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## Explorations in political economy of reforms

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# **EXPLORATIONS IN POLITICAL ECONOMY OF REFORMS**

**Dalibor Roháč**  
**Doctor of Philosophy (PhD) in Political Economy**

June 2014

## **Abstract**

This thesis studies the role of incentives and beliefs in changes in economic policies and institutions, particularly during economic transitions. We motivate our work by providing a review of the literature on post-communist economic transitions in the introductory chapter. In Chapter 2, we outline the methodological strategies used in the thesis. In the subsequent chapters, this broad research agenda is translated into three self-contained research projects, which study different attributes of cognitive and incentive problems arising in processes of institutional change.

Chapter 3 uses the idea of policy credibility to explain the persistence of food and energy subsidies in Egypt and provides a discussion of how appropriate reform design can help overcome the lack of credibility. Chapter 4 outlines a rational choice-based explanation for the rise of political Islam in the Middle East. The explanation revolves around the claim that religious political groups are able to address the problem of credible commitment, ubiquitous in new and emerging democracies. Chapter 5 studies the role of cognitive constraints in shaping transitional outcomes, with a focus on post-communist Czechoslovakia. Besides presenting evidence for systematic differences in beliefs between the Czechs and the Slovaks, it argues that measurable differences in market attitudes affected policy choices in both countries and led to different transitional outcomes. Chapter 6 concludes.

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# 1 Towards a New Political Economy of Reforms<sup>1</sup>

## 1.1 Introduction

Economists often provide input into decisions about public policy. That is not surprising. By the standards of social sciences, economics has a uniquely sophisticated methodology and a rigorous set of tools of theoretical and empirical analysis. The appeal of economics lies also in its substantive subject matter, which includes the questions of wealth, unemployment, and economic growth – all of them of interest to the public and to policymakers.

However, it is not obvious that economists are singularly well equipped to understand the processes of policy change or to provide advice to policymakers. The aim of this thesis is to help outline a research agenda for economists and social scientists who wish to gain a better grasp of the processes of policy change. It will highlight the importance of two sets of factors, both of them largely omitted from traditional methods of policy analysis used by economists. The first set of factors is related to the incentive problems involved in changing policies and institutions. We will call these *incentive-related constraints* on policy making. Policy changes that are in the public interest, however defined, may not occur if policymakers are self-seekers, and if sufficient mechanisms aligning their self-interest with the public interest are not in place. Incentive problems in politics can take many different forms and may affect the voters, policymakers, or bureaucrats charged with implementing a policy change. In practical terms, these steer policymakers and economic agents towards actions that are not in the public interest, broadly understood, and encompass rent-seeking, patronage, corruption, or reneging on electoral promises. This thesis will focus on a particular category of incentive problems, namely problems of credibility. Policies can be understood as contracts between the

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<sup>1</sup> This chapter draws heavily from material published in *Economic Affairs* as Roháč (2013b) and Roháč (2013d).

population and policymakers. Like private contracts, they are based on promises that can be broken. The question of how the risk of reneging on promises affects the set of possible policy outcomes and the characteristics of the political arena will constitute one set of questions that this thesis will purport to address.

The second set of factors explored in this thesis concerns the beliefs and mental models used by policymakers and the public which constrain policy making. We will call these *cognitive constraints* to policy making. Such constraints include factors such as ideology and beliefs, as well as various ways in which agents in the real world appear to depart from standard economic assumptions of cognitive rationality. One hypothesis, explored in Chapter 5 of this thesis, is that measurable differences in policy preferences can affect policy choices as well as the economic, social, and political outcomes of policies and formal institutions.

This introductory essay discusses the mechanisms through which cognitive and incentive-related constraints affect policy making and how they can help explain the variation in policies and institutional arrangements adopted during economic transitions.

In addition to discussing the mechanisms through which incentives and beliefs matter, this chapter illustrates the relevance of cognitive and incentive-related constraints by providing a discussion of the existing literature on post-communist economic transitions. According to our interpretation, the more successful transition strategies were the ones that were more robust with regard to incentive-related constraints and to cognitive constraints. Reform successes thus focused policymakers' attention on variables that they could control and provided a simple laundry list of policies that were necessary – though not sufficient – for the success of transitions, and enabled policymakers circumvent the problem of credible commitment, ubiquitous in transitional environments.

The three core chapters in this thesis provide case studies of policy making in transitional environments, which illustrate the relevance of an approach that revolves around incentive problems and beliefs as critical factors shaping policy changes and reforms. Chapter 3 focuses on the problem of subsidy reform in Egypt, where wasteful subsidies to consumer goods ranging from diesel oil to tea have withstood attempts at reform. The interpretation offered revolves around the problem of credibility and the inability of policymakers to commit to a reform path that would not be reversible. Chapter 4 also focuses on the countries of Middle East and North Africa and provides an exposition of the effects credibility problems may have in shaping political environments in new and emerging democracies. Specifically, the paper shows how a lack of credibility in making electoral promises, pervasive among most political organisations in the region, has given a distinct electoral advantage to Islamic parties which possess brand names and reputation that can be used towards making believable promises about policies. Finally, Chapter 5 focuses on the role of cognitive factors in shaping policy outcomes. Drawing on survey data from post-communist Czechoslovakia, the paper provides evidence suggesting that differences in beliefs about markets and economic policy between the Czechs and the Slovaks could have accounted for the different transitional trajectories of the two countries.

Our approach, combining an emphasis on incentive-related and cognitive problems, is not entirely original. Some scholars, most notably Eggertson (2005), Leighton and López (2013) or Rodrik (2014), have tried to integrate political economy and models of belief formation in order to explain institutional change. Similarly, Ostrom's (1993) distinction between epistemic choice and public choice can be seen as an attempt to formulate a research agenda focused on the evolution of institutions and policies. Caplan (2007) links the departures from assumptions of cognitive rationality with incentive problems existing in politics in order to explain the persistence of bad

policies. Similarly, Kuran (1995) explores the implications for the political process of the divergence between privately held beliefs and those displayed publicly. In recent years, a research agenda has emerged in political economy around the idea of robustness of institutions and policies. Robustness is understood as the susceptibility of institutions and policies to produce desirable social and economic outcomes even under less-than-ideal assumptions about the knowledge and benevolence of individuals and policymakers (Leeson and Subrick 2006, Pennington 2011). This collection of essays seeks to make a contribution to that line of enquiry, with a focus on questions of transitions, reforms, and policy change.

The study of incentive problems in politics has a long history in political economy and neighbouring disciplines. Accounts based on poorly or well-aligned incentives in the political arena are at the heart of many explanations of modern economic growth, most prominently by Acemoglu and Robinson (2012) or North, Wallis and Weingast (2009). The roots of the study of incentive problems in politics can be found in the classical contributions of Buchanan and Tullock (1962), Tullock (1967) and Buchanan (1967), which have given rise to several streams of literature, both theoretical and empirical, and varying in their degree of technical sophistication.<sup>2</sup>

Credible commitment is a recurrent issue in this area of literature. Originally developed to explain the behaviour of central bankers,<sup>3</sup> the idea that private agents might not believe the announcements made by policymakers about the future trajectory of policy has permeated the study of various aspects of policy making, ranging from regulation and taxation to electoral behaviour.<sup>4</sup> Martinelli (1993) uses the framework of credibility constraints and other public choice problems affecting the political process to explain

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<sup>2</sup> Good, though somewhat dated, overviews of the different approaches and topics are provided by Mueller (2003) or Persson and Tabellini (2002).

<sup>3</sup> Kydland and Prescott (1977), Rogoff (1985).

<sup>4</sup> See, e.g., Keefer and Knack (2007), Keefer and Vlaicu (2008), Coyne and Boettke (2009), Talercio (2004), Campos and Esfahani (2000), Frye (2004), and Boettke (1995).

the dynamics of economic reforms in transitional countries. Two essays included in this thesis – Chapters 3 and 4 – will also explore the implications of credibility problems for policy reforms and for the character of political markets in transitional environments.

While the research on incentive problems in political decision-making is developed and well-integrated with the economic profession, the exploration of the effects of beliefs and cognitive limitations on policy making or institutional change remains limited. At an intuitive level, cultural norms and beliefs may be important since they impose constraints on individual behaviour. For example, experimental evidence shows that cultural backgrounds are associated with different levels of cooperation in public goods games.<sup>5</sup> At a microeconomic level, Di Tella et al. (2008) find an association between left-wing beliefs and individual experience with crime. But can differences in beliefs be associated with systematic differences in aggregate economic outcomes? The idea that institutions are underpinned by a set of beliefs held by individuals living in a society is explored in North (2007). Tentative pieces of evidence suggest that beliefs – or ‘culture’ – might be an important factor shaping institutional and economic outcomes. In a study of determinants of security of private property, Williamson and Kerekes (2011) find that informal constraints are significant, trumping the importance of formal institutions. Furthermore, the variation in informal institutions is linked to differences in output across countries.<sup>6</sup> Similarly, Tabellini (2010), for example, identifies an empirical link between cultural norms and economic outcomes, showing that pro-individualistic and egalitarian cultures are associated with higher levels of economic development.

Unfortunately, very little is known about the formation of beliefs and the specific mechanisms through which beliefs affect measurable outcomes. Di Tella and MacCulloch (2009) explain the joint incidence of leftist beliefs, heavy regulation and corruption. In their setting, leftist beliefs are endogenous to the experience of

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<sup>5</sup> See, e.g., Gächter and Herrmann (2009) or Esarey et al. (2012).

<sup>6</sup> Williamson (2009).

‘unpleasant’ capitalists and serve as a mechanism reinforcing heavy regulation, which breeds further corruption. In a different vein, Alesina and Fuchs-Schuendeln (2005) study the effects of communism on the policy preferences of East Germans after the reunification, providing evidence for systematic differences in beliefs between the East and West Germans. Working in the context of transitional economies, Runst (2013) explains the formation of new firms by differences in cultural norms and attitudes towards entrepreneurship. The last chapter of this thesis focuses on the link between market-related beliefs and policy formation, using data from post-communist Czechoslovakia. The chapter provides evidence for a divergence of beliefs between the Czechs and the Slovaks and provides a narrative that explains how that divergence can account for the different transitional trajectories of the two countries – without trying to formally solve the underlying identification problems. The work in Chapter 5 thus bears connection with the earlier research done by Miller, Hesli and Reisinger (1994) who find that nationality mattered for the support of reforms in the early 1990s, and Landier et al. (2008) who investigate the sources of ‘capitalism aversion’ in the transitional countries, as well as the work by Denisova et al. (2007) who investigate the sources of support for revising privatisation in transitional countries.

## **1.2 The two sets of constraints**

One of the goals of this thesis – ambitious as it may sound – is to gain a better understanding of how changes in policies occur, what explains their durability, and provide a plausible account of why similarly designed reforms may lead to different outcomes in different places. That context matters and that policy prescriptions do not always travel well is an accepted fact. However, systematic theories of what shapes the success and failure of policy changes are not always readily available.<sup>7</sup>

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<sup>7</sup> The existing literature on policy durability has mostly focused on the United States and has not produced a systematic model of accounting for differences in durability of policies. See, e.g., Patashnik

The claim of this section is that two factors help explain the observed variation: firstly, the differences in incentives facing voters, politicians and bureaucrats and, secondly, the differences in the beliefs and mental models used by voters and politicians.

### **1.2.1 Incentive constraints**

This thesis follows the classic understanding of public choice as the economic study of political decision-making that starts from the same motivational assumptions as economic analysis of behaviour on private markets. Incentives constrain economic reformers at a variety of levels. Most fundamentally, they affect voters' choice between different policy platforms. A rational voter has little incentive to gather pertinent information about different policy platforms, and as a result, voters will, in the aggregate, remain rationally ignorant, generating a net negative externality in the form of uninformed electoral choices. Caplan (2007) takes this line of reasoning one step further, providing evidence for the view that political failure is not driven by rational ignorance, but rather by systematically biased beliefs, from which individuals derive utility. In other words, the political process becomes an avenue through which systematically biased beliefs can be expressed, at a low cost to individuals, yet at a significant cost to the society as a whole.

Another reason why socially desirable policies are not always adopted is related to the different levels of organisational costs in different groups.<sup>8</sup> Small, well-organised interest groups are in a better position to solve coordination problems and prisoner dilemma-type situations than the public at large, and are therefore more effective in influencing the outcomes of the policy-making process.<sup>9</sup> Typical manifestations of this phenomenon include policies that are costly to the median voter but beneficial to well-

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(2000, 2003, 2008), Maltzman and Shipan (2008), and Berry, Burden and Howell (2006), Moe (1989). On policy durability in the context of developing or transitional countries, see Campos and Esfahani (2000), Frye (2004), and Boettke (1995).

<sup>8</sup> Olson (1971).

<sup>9</sup> See Mitchell and Munger (1991) for an overview.



organised interest groups, such as trade barriers, occupational licensing, and other barriers to market entry. Extreme examples involve the capture of government and regulators by interest groups, resulting not only in rules and policies that benefit the interest groups but also in their explicit participation in their design and implementation.<sup>10</sup>

Incentive-related constraints can act either ex-ante, preventing efficiency-enhancing reforms from occurring in the first place, or they can apply ex post, leading to the reversal of reforms that have already been undertaken. Time inconsistency and credibility problems can therefore be described as ex-post constraints on reforms.<sup>11</sup>

Economic policies can be seen as contracts between politicians and a decisive part of the population, needed for the politicians to control the government. Such contracts, broadly understood, can be either contracts between policymakers and a majority of the population or, in the case of a lack of democratic governance, between policymakers and oligarchic groups that exercise political control over societies. True, contracts between politicians and the population do not allow for a central authority to enforce them – as is often assumed in neoclassical economics. Our approach follows Greif's (1997) demonstration that contracts can emerge even without legal enforcement, by virtue of design of self-enforcing mechanisms. Similar mechanisms may emerge – or fail to emerge – in the political realm. Because this thesis is not seeking to make a theoretical contribution but rather to explore how some widely accepted rational choice-based intuitions can explain significant patterns in the real world, it refrains from explicit formal modelling of contracting, which tends to be highly technical.<sup>12</sup> However, the main idea of the policies-as-contracts approach is that politicians seek to obtain the support that enables them to control the government apparatus in exchange for policies

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<sup>10</sup> Stigler (1971), Laffont and Tirole (1991) .

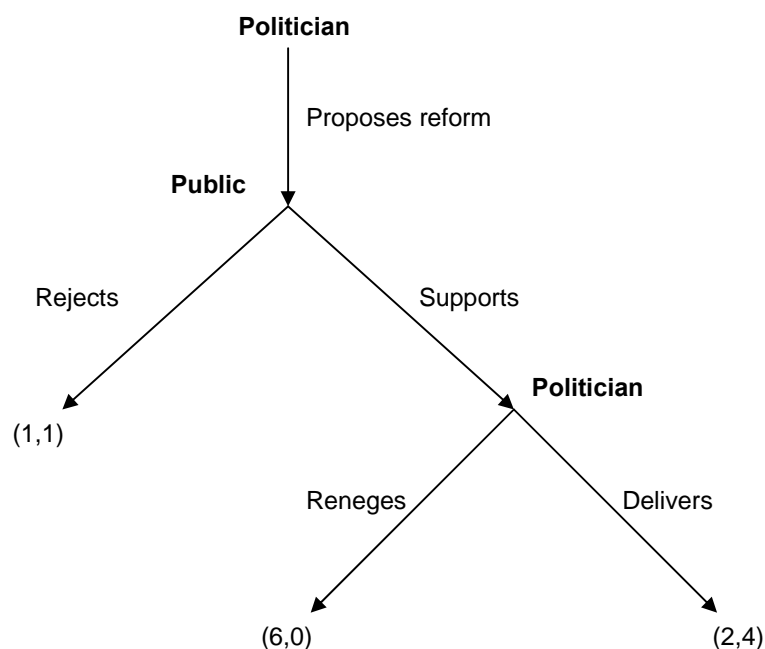
<sup>11</sup> For examples of the work on policy credibility in the context of development and emerging democracies, see Keefer and Vlaicu (2008), Keefer and Knack (2007).

<sup>12</sup> See, e.g. Hart and Holmstrom (1987), Salanié (1997), Macho-Stadler and Perez-Castrillo (2001).

that deliver benefits for the part of the population that is needed to control the government. As with other contracts, these are vulnerable to situations when politicians face incentives to deviate from the announced path.

The situation is visualised on Figure 1. At the first stage of the game, the politician proposes a welfare-enhancing reform. At the second stage, the public decides whether or not to support the politician's platform. If the platform is rejected, both the politician and the public receive a default pay-off of 1, corresponding to the status quo. If the public supports the platform and the politician is elected, the politician has the option of either delivering on their promise, generating a pay-off of 2 to the politician and a pay-off of 4 to the voter. If the politician chooses to renege – e.g. by seizing the whole surplus from the reform – they will end up with a pay-off of 6, leaving with the public with a pay-off of 0. This setting assumes that the politician can seize the whole surplus of the reform without any loss of economic efficiency; that assumption can easily be relaxed to allow for a dissipation of a part of the welfare gains in case the politician reneges, as long as the pay-off the politician can seize is larger than the pay-off she receives should she deliver on her promise.

Figure 1 The problem of commitment



In a one-shot game, the outcome (Supports, Delivers) is not attainable because in the final stage of the game the politician is tempted to hijack the surplus created by the reform by reneging, creating a classic time inconsistency problem. The only subgame perfect equilibrium in the game is the one in which the public rejects reform, leaving both the public and the politician with a lower pay-off compared to the Pareto superior outcome that the reform would have brought if implemented. A rational public will reject the reform proposal unless the structure of the game is changed in a way that precludes the politician from reneging in the final stage or makes reneging costly for him. In other words, the politician needs to find a way of making a credible commitment.

The significance of credibility problems as constraints on economic policy making in transitional environments is a theme explored by Boettke (1995). Historically, communist economies were subjected to numerous reforms. In the USSR alone, significant reforms occurred in the 1920s, 1950s, 1960s and 1980s. All of them, Boettke

argues, either failed or were reversed at some later stage. In such circumstances, the credibility of reformers, especially if they were connected in any way with the previous political elite, was contestable. In such an environment, piecemeal reforms were perceived as reversible and lacking credibility. One way that the new political elite could signal a durable commitment to the new economic and political order was to use the brief window of opportunity for rapid and encompassing reforms. True, in an ideal environment, a carefully designed sequence of partial reforms could have worked better, if the commitment of the elites to the new economic system was known. However, gradual sequencing was unlikely to be a viable reform strategy in a situation in which such commitment was in doubt.

### **1.2.2 Cognitive constraints to economic reforms**

Cognitive constraints to economic policy have several dimensions. At a fundamental level, any decision-making problem entails three different elements: (1) preferences, (2) objective constraints, and (3) choice variables. Economists often take these as given and try instead to understand the mechanisms through which changes in objective constraints modify individual decisions – hence the analysis of comparative statics and comparative dynamics. Yet, all three of the factors listed above are embedded in a deeper cognitive framework. Preferences, for example, are tied to the perception of one's identity.<sup>13</sup> One's knowledge of choice variables and objective constraints is contingent on both the information available to the individual and on the mental models that one is using to describing the functioning of the physical and social world. A research programme that acknowledges that the formation of beliefs can be an important factor in the political realm has to make at least a passing reference to the growing body of literature on behavioural economics,<sup>14</sup> which seeks to understand the departures of individual cognition from the neoclassical rationality assumptions. This thesis has no

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<sup>13</sup> Akerlof and Kranton (2000).

<sup>14</sup> See, e.g., Camerer, Loewenstein, and Rabin (2011).

such overarching ambitions. However, in Chapter 4 it explores the potential effects that individual beliefs have on the feasibility of different policies, while being conscious of the fact that a more systematic exploration of the drivers of individual belief formation would go beyond the current scope of the three essays this thesis encompasses.

The problem of the role of cognition in policy making is related to the question of the knowledge available to policymakers. In his work on the subject, Friedrich von Hayek argued that the knowledge that would have been necessary to effectively control social and economic processes is never given to anyone in its entirety, cannot be centralised, and would not even exist outside of a market-based discovery process.<sup>15</sup> Although of acute importance for policy making, this issue remains conceptually separate from the notion of cognitive constraints. Cognitive constraints go beyond incomplete information problems as they capture how institutional and policy outcomes are affected by individuals' beliefs about the functioning of the social world – and not just by the information available to them. In other words, in order to feed into decision-making, any information that individuals collect needs interpretation. In this sense, this thesis has the ambition to go beyond the dominant approach in the field of 'new political economy', typically limited to the study of how limited information affects choices in political processes<sup>16</sup> but is mostly silent on the issue of how cognition and belief formation affect decision-making in the political sphere.

One way of approaching this broad issue question is to understand that preferences, beliefs and mental models are shared and reflected in cultural norms guiding human cooperation, shared understanding of individual behaviour as right or wrong, as well as the degree of trust among individuals. Moreover, people have intuitive mental models of the functioning of the economy and of the effects that different policies and institutions have on the economic and social outcomes. Such intuitive accounts shape

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<sup>15</sup> Hayek (1945, 1948).

<sup>16</sup> Besley (2007: F580).

individual responses to policies and institutions in societies. In other words, institutions and policies are nested in a number of rules, practices and shared expectations, called *mētis* by Boettke et al. (2008) Originally, the concept of *mētis* is attributed to the political scientist and anthropologist James Scott (1998) who defined it as follows:

*Mētis* represents a useful array of practical skills and acquired intelligence in responding to a constantly changing natural and human environment. (Scott 1998: 313, emphasis added)

*Mētis* is thus the set of shared preferences, beliefs, and mental models, reflected in formal and informal institutions, and generating practical knowledge about solutions to social problems of human interaction.<sup>17</sup> The examples would include attitudes towards cooperation in repeated prisoner dilemma situations – related to trust levels prevailing in the society – but also the approbation that is associated with different forms of behaviour, including risk-taking, individual pursuit of material self-interest, rent-seeking, or attitudes towards unequal distribution of resources. In this understanding, *mētis* also encompasses the positive mental models of the social world that individuals in a society use. Do they understand the market process as a zero-sum game? What do they believe the origins of economic wealth are?

A testable corollary of this line of thinking is explored on a case study in Chapter 5. Specifically, its main idea is that the likelihood of the success of economic reforms depends on the congruence of the policy change and the underlying *mētis*. Boettke et al. (2008) posit that the durability of reforms or changes in formal institutions – their ‘stickiness’ – is determined by their relationship with the existing informal institutional structure. Formal institutions which are compatible with the prevailing set of deeply ingrained informal institutions are more likely to ‘stick’ than institutions that are at odds

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<sup>17</sup> Mantzavinos et al. (2004: 77).

with the prevailing cultural practices and local knowledge embodied in the set of informal norms.

The interaction between *mētis* and formal institutions can lead to different outcomes, according to whether the informal and formal institutions diverge, and whether formal institutions are effective.<sup>18</sup> If the two types of institutions are convergent, no conflicts will arise. In cases where the formal institutions are ineffective, *mētis* can serve as a substitute for formal institutions. However, formal norms, which are not congruent with the *mētis*, would enter into conflict with prevailing informal institutions. The outcome of this conflict is not clear. In cases when the new formal norms are ineffective, due to the lack of proper enforcement, they will not replace the operating informal norms and will become irrelevant for private agents. The situation is more complicated in the case when the formal norms are effective, e.g., through proper enforcement. One can expect that informal structures will accommodate the new formal rules, but the conflict between formal and informal norms will generate unintended consequences, as individuals are likely to attempt operating outside of formal rules, either by contracting around them or by creating black markets.<sup>19</sup>

The interaction between the *mētis* and formal norms occurs also at the level of the political process, through which the *mētis* is reflected in the policy agendas commanding popular support. To be sure, in an autocracy or in a totalitarian regime, the responsiveness of the political process to the *mētis* prevailing in the country might be limited. In contrast, in a democratic political process, elections will constitute both a selection and feedback mechanism that will ensure a certain degree of responsiveness to the *mētis*. Even if we understand that instrumental voting is pointless,<sup>20</sup> it is possible to understand elections as a device that individuals can use to express their political and

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<sup>18</sup> Helmke and Levitsky (2004: 728).

<sup>19</sup> Miron and Zwiebel (1995).

<sup>20</sup> Tullock (2006).

cultural views and signal attachment to a particular set of informal norms.<sup>21</sup> Through elections, voters are thus able to select – however imperfectly – political platforms that reflect the preferences, values and expectations of a large part of the population. And when politicians deviate from the prevailing *mētis*, either through their policies or through their rhetoric, they run the risk of being penalised by an electoral defeat.

This relates to the earlier distinction between the ex-ante and ex-post constraints facing economic and political reformers. Ex-ante constraints prevent policymakers from making certain moves from the outset. Ex-post constraints are driven by the expected popular and political reaction to certain policy moves. Unpopular policies are likely to lead to a popular backlash and to their reversal – and that fact represents an ex-post constraint to any reformer. The interaction of economic reforms with the *mētis* is an ex-post constraint – furthermore it is one that might not always be foreseen by the policymaker.

### **1.3 Understanding economic transitions**

This section revisits one of the significant economic debates of the 1990s, surrounding post-communist transitions in Central and Eastern Europe. Its purpose is to show that an analytical approach that relies on incentive-related and cognitive constraints, accompanied by an appreciation of the limited nature of knowledge available to policymakers, is a potentially fruitful avenue for exploring the effects of different transitional strategies, as well for explaining the factors behind the actual policy choices made during post-communist transitions.

The economics profession has been traditionally divided between those who advocated a rapid sequence of wholesale reforms and those who claimed that the transition needed to be slow and gradual. Nobel laureate Joseph Stiglitz (2002) commented: “You had the undermining of the basic social fabric of society. You didn't have growth; you had

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<sup>21</sup> Fiorina (1976), Schuessler (2000).



decline. You had increase in poverty rather than the fruits that capitalism was supposed to bring.” Both approaches saw the transition as a problem in optimal sequencing and timing of policy changes. The differences between the two approaches were related to the assessment of effects of rapid versus gradual policy changes, the dislocations that the transition would induce, and on other matters; yet the two approaches shared a common outlook on policy making as an exercise unconstrained by cognitive limitations and incentives facing policymakers and the public. This stands in contrast to the approach adopted by this thesis, which sees policy-making and policy reforms as largely endogenous.

The proponents of radical approaches to reform were correct in advocating radical reforms on margins that were amenable to discretionary changes in policies and legal rules – privatisation, liberalisation, inflation and deficit reduction, as well as the low-hanging fruit in the form of statutory changes affecting the status of private property, as suggested by the proponents of ‘shock therapy’. As ‘gradualists’ pointed out, however, these were not sufficient for a successful transition. A market economy needed institutional underpinnings. Yet, the rules of market order could not be designed and imposed on market participants from above in no time.

An evolutionary process needed to guide the emergence of new legal rules, and formal and informal institutions. It would be mistaken to think that such rules and institutions could have been created before the actual markets existed. Furthermore, there are few, if any, known ways of creating, through the means of public policy, the informal and cultural norms needed to support the market economy.

One corollary of the argument outlined in section 1.2 is that successful economic reforms needed to be perceived as credible and need to be grounded in the knowledge and beliefs available to policymakers. As a result, the policy changes that were perceived as irreversible – or too costly to undo – and required little in terms of

policymakers' knowledge – e.g. which rely on simple rules of thumb or laundry lists – were likely to fare better than reforms that only perform well under favourable assumptions about knowledge available to policymakers and their motivations. Because the 'shock therapy' limited the scope for discretion and provided policymakers with simple 'laundry lists' of desirable policy prescriptions, it limited the need to collect information, interpret it, and exercise judgment. And because it advised to pursue reforms quickly and in a wholesale fashion, it was also suited to overcome the problem of credible commitment, which plagued gradual and partial reform strategies.

Ultimately, the success of reforms in post-communist transitions was dependent on whether they were congruent with the underlying *mētis*. This section will therefore discuss the available evidence, unsystematic as it is, which links differences in attitudes towards various aspects of the market economy and policy outcomes in Central and Eastern Europe.

### **1.3.1 Transitions from what?**

To what extent does it make sense to classify economies within different “economic systems” between which they might transition? Kornai (2000) provides a simple dichotomy between two kinds of economic systems: those that fall within the capitalist spectrum and those that can be seen as socialist. Similarly, there are numerous historical variants of what can be understood as the same socialist system. The dividing lines between two systems are as follows:

- whether the political power is friendly to private property and private markets, or not,
- whether the economy is dominated by private ownership or state and quasi-state ownership,

- whether the economy is coordinated through market means or through bureaucratic decision making,
- whether economic agents are subjected to hard or soft budget constraints,
- whether most markets are in equilibria or whether the economy suffers from chronic shortages.

While this list of characteristics provides us with a rough set of metrics, Boettke (1992) emphasises that even the former USSR was a case of non-comprehensive economic planning with a large market economy – albeit with one that was “politically manipulated to yield profits to those in position in power” (Boettke 1992: 139).<sup>22</sup> The distinctive feature of a Soviet-type economy was, according to Boettke, a vast network of interlocking monopoly suppliers who relied on market signals as well as on commands from the power centre. Firstly, producers in a Soviet-type economy were responsive to price signals coming from the world markets and they were also responsive to signals established in the informal economy – very often in the form of bribes. As a result, while Kornai is correct to point out the dominant role of “bureaucratic coordination” in socialist economies, this is essentially a manifestation of a market-based coordination – albeit one with distorted incentives. Moreover, the classification of a country as “capitalist” or “socialist” cannot be based solely on measures of the size of government alone, as the government plays a significant and varying role in most market economies.<sup>23</sup>

For decades, prominent neoclassical economists maintained that centrally planned economies could perform as well as competitive markets.<sup>24</sup> Murrell (1991a) showed that

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<sup>22</sup> See also Anderson and Boettke (1997).

<sup>23</sup> In fact, most economists, including Besley and Persson (2011), would agree that such a role is essential to the proper functioning of markets and to economic growth.

<sup>24</sup> Most prominently, as late as in 1989, Paul Samuelson and William Nordhaus provided probably the most telling summary of their views on the workings of a centrally planned economy in their best-selling textbook: “[C]ontrary to what many sceptics had earlier believed (...) the Soviet economy is proof that (...) a socialist command economy can function and even thrive” (Samuelson and Nordhaus 1989: 837).

neoclassical economics played only a limited role in explaining the deficiencies of centrally planned economies. The core of his argument was that the distinctions made by neoclassical economists between socialist and capitalist economies – distinctions that tended to ignore the institutional context – were not relevant in the real world. For instance, empirical studies of Soviet industry<sup>25</sup> showed similar levels of technical efficiency as market economies. Similarly, the foreign trade of planned economies – used as a proxy for the overall production structure – did not appear to be vastly different from that of capitalist economies. Finally, the estimates of production functions in communist economies – by Thornton (1971) or Whalley (1976) – pointed to efficiency losses that did not appear to be significantly different from estimates obtained from data from market economies. That does not mean that Soviet-type economies were not economically inferior to market economies. It means, however, that their deficiencies may have lain elsewhere than in the attributes that standard economic analysis could identify easily.

In the socialist calculation debate, advocates of central planning used the tools of general equilibrium analysis to derive conditions under which planning could generate economic outcomes equivalent to the general equilibrium.<sup>26</sup> It was almost exclusively the economists working in the Austrian tradition<sup>27</sup> who were able to articulate why such efforts amounted to a blackboard exercise. In the real world, the knowledge needed for economic planning was tacit and decentralised, and would not exist outside of a market-based discovery process. The price mechanism is a way of generating and communicating knowledge and using it to make economic decisions. By eliminating this mechanism, socialism placed unreasonable informational demands on the planners who were thus supposed to gather the knowledge of the “particular circumstances of

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<sup>25</sup> E.g., Danilin et al. (1985).

<sup>26</sup> Taylor (1929), Lange (1936, 1937), Lerner (1934).

<sup>27</sup> See Mises (1920) and also Hayek (1935, 1945) for the key contributions. Lavoie (1985) and Boettke (2001) provide an overview of the history of the debate.

time and place” (Hayek 1948: 80). The reason for the failure of the economic profession to appreciate this argument may be related to the weight attributed by economists to the use of the general equilibrium model of the economy as the dominant tool of analysis.<sup>28</sup>

While the point about the role of markets, prices, and competition seems trivial at first sight, it remains underappreciated by the mainstream of the economic profession. Zinnes, Eilat and Sachs (2001: 149), for instance, claim that the principal rationale for privatisation was the existence of asymmetric information and incomplete contracts between planners and enterprise managers.<sup>29</sup> While those were valid concerns, they hardly constituted the crux of the matter. In fact, the fundamental purpose of privatisation in post-communist countries was to restore the institutions – most importantly private property – that would enable rational economic calculation within the economy by creating genuine markets for factors of production.

The second, more mundane, reason for the failure of socialism had to do with the perverse incentives created by a system where economic decisions were based on a process of bargaining over output and resources between factory managers and planners. Even if we agree that central planning could, in principle, deliver efficient outcomes, it would remain unclear whether the individual conduct needed to attain such outcomes was incentive-compatible.<sup>30</sup> In planned economies, factory managers were incentivised to provide the planners with information that led them to either increase the factors of production given to companies and/or decrease the level of output relative to what it would otherwise have been.<sup>31</sup> Misaligned incentives also led the planners to set

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<sup>28</sup> See Levy (2011) and also Levy and Peart (2006). Also, Boettke (1997) argues that a broader failure of the economic profession has led to ‘a flight from reality’ and to the development of either empirically irrelevant or ideologically motivated work.

<sup>29</sup> See also Shleifer (1998).

<sup>30</sup> See, on this matter, Shleifer and Vishny (1994).

<sup>31</sup> Weitzman (1980).

prices at artificially low levels, in order to induce shortages on product markets, as these created rents for those involved within the political process.<sup>32</sup>

### **1.3.2 Between Washington Consensus and neo-institutionalism**

The central divide of the debate in the 1990s was between those who claimed that rapid, systemic changes needed to be undertaken quickly at the beginning of the transition<sup>33</sup>, and those who believed that the institutional and structural change needed to occur in a piecemeal way, with careful sequencing that would limit the social losses of the transition.<sup>34</sup>

The policy of rapid systemic changes, with a strong focus on restoring macroeconomic stability was called the Washington Consensus by Williamson (1990)<sup>35</sup> because it reflected at the time the dominant view of the US Treasury, the IMF and the World Bank about policies that either were or should have been adopted by Latin American countries in the 1980s.<sup>36</sup> Table 1 below summarises ten key prescriptions of this approach.

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<sup>32</sup> See Levy (1990).

<sup>33</sup> See, e.g., Lipton and Sachs (1990).

<sup>34</sup> See, e.g., Murrell (1991b) or Hare (2001).

<sup>35</sup> More on Washington Consensus can be found in Williamson (1990), Williamson (1993), Williamson (1997) and in Kolodko (2000).

<sup>36</sup> For a review of the thinking and principles behind this approach, see also Balassa et al. (1986).

Table 1 Washington Consensus

<b>Policy</b>	<b>Meaning</b>
<i>Fiscal discipline</i>	“Budget deficits ... small enough to be financed without recourse to the inflation tax.”
<i>Reorienting expenditure</i> <i>public</i>	“...redirecting [public] expenditure from politically sensitive areas [that] ...receive more resources than their economic return can justify ... towards neglected fields with high economic returns and the potential to improve income distribution, such as primary health and education, and infrastructure.”
<i>Tax reform</i>	“Tax reform [so as to broaden] the tax base and cut ... marginal tax rates.”
<i>Financial liberalisation</i>	“Financial liberalisation, [involving] an ultimate objective ... of market-determined exchange rates.”
<i>Unified and competitive exchange rates</i>	“...a unified ... exchange rate ... at a level sufficiently competitive to induce a rapid growth in non-traditional exports.”
<i>Trade liberalisation</i>	“Quantitative trade restrictions should be rapidly replaced by tariffs, and these should be progressively reduced until a uniform low rate of 10 [to 20] per cent is achieved.”
<i>Openness to foreign investment</i>	“Barriers impeding the entry of foreign [direct investment] should abolished.”
<i>Privatisation</i>	“Privatisation of state-owned enterprises.”
<i>Deregulation</i>	“[Abolition of] regulations that impede the entry of new firms or restrict competition.”
<i>Secure property rights</i>	“The legal system should provide secure property rights without excessive costs and make these available to the informal sector.”

Source: Williamson (2004).

Very quickly, partly through the work of Jeffrey Sachs<sup>37</sup> and others,<sup>38</sup> the idea that rapid macroeconomic stabilisation was the key to success in economic transitions was translated into policy practice in the transitional world. Apart from its emphasis on containing inflation, budget deficits, and external imbalances, rapid privatisation and liberalisation – both on the domestic microeconomic front and also with regard to external trade and capital flows – were of the essence. The approach emphasised the existence of complementarities between various elements of policy reform. Plausibly, price liberalisation without prudent monetary policy would result in rampant inflation rates. Likewise, without the imposition of hard budget constraints, liberalisation would not induce desirable behavioural responses on the part of the firms.

The emphasis on liberalisation and tackling macroeconomic imbalances was motivated by the view that disequilibrium prices were the main problem of the socialist economy.

<sup>37</sup> See, e.g., Lipton and Sachs (1990), Sachs (1993) and Sachs (1994).

<sup>38</sup> See Balcerowicz (1994) or Klaus (1990), among many.

Once the hindrances to the functioning of markets were lifted, competitive forces would restore the equilibrium, resulting in an efficient allocation of resources. Speed was another important consideration, since the fall of communism offered a unique and limited ‘window of opportunity’<sup>39</sup> that could have been closed by the rise of political populism and factions that would have been unsympathetic to economic reform.

Roland (2001) discusses the experience of post-communist transition and concludes that policy prescriptions derived from the Washington Consensus were not satisfactory: “If anything, the experience of transition shows that the policies of liberalisation, stabilisation and privatisation that are not grounded in adequate institutions may not deliver successful outcomes.” The alternative to the Washington Consensus or ‘shock therapy’ emphasised the primacy of institutions for economic development and underscored the political economy dimension of reforms. Peter Murrell (1992) emphasises the idea that socio-economic mechanisms are in fact information-processing devices and that societies rely on local knowledge (p. 83), very much in the spirit of Hayek’s work.

Whereas the Washington Consensus relied on price theory as its main tool of analysis, the neo-institutionalist perspective used the tools of non-cooperative games, stressing the potential for multiple equilibria. This perspective stressed the role played by the aggregate uncertainty about the outcomes of the transition,<sup>40</sup> driven by the multiplicity of potential equilibria. Moreover, neo-institutionalism rejected the emphasis on the rapid implementation of economic reforms, arguing instead that with the possibility of inefficient equilibria, big bang changes could lock countries into irreversible institutional outcomes that could be crippling for economic development.

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<sup>39</sup> Kingdon (1984).

<sup>40</sup> ‘Aggregate uncertainty’ refers to the uncertainty about the global outcome of a policy move, i.e. about whether it might bring about an overall welfare improvement or not. In contrast, “individual uncertainty” refers to the uncertainty about the effects of a particular policy move on an individual, or a group of individuals. In technical terms, a situation of aggregate uncertainty is characterised by a stochastic evolution of the distribution of individual outcomes. (Burgin and Bernhardt 1992).



Besides the question of timing and sequencing, where they advocated implementing more popular reforms first, in order to build political support for further changes, the neo-institutionalists also emphasised the importance of creating a sound legal framework before privatisation and liberalisation took effect, and a large role for the government in the process of control and restructuring of state-owned enterprises. As emphasised by Murrell (1991b), the neo-institutionalists were worried by the existence of externalities in the creation, design and destruction of large organisations. The destruction of pre-existing institutions, guiding the functioning of economic organisations existing under socialism could be inimical, in Murrell's view, to the development of the nascent private sector. In other words, this view presumed the existence of a trade-off between the creation of new private sector and the speed of decentralisation and privatisation of the government-run economy.

Neo-institutionalists therefore supported the creation of dual-track liberalisation programmes, similar to the one employed in China after 1978. The emergent private sector should be governed, according to Murrell (2006), by new, market-friendly, institutions. At the same time, the old economic mechanisms would remain in place and would guide the functioning of the old sector in order to prevent its convulsion. In this manner, the output contraction that occurred in the 1990s would have been prevented and, in the meantime, the institutions needed for a smooth functioning of the market economy would have been introduced gradually.

The debate among the advocates of the Washington Consensus and those defending the evolutionary-institutionalist perspective was heated but not always motivated by deep differences in the understanding of institutional change. Roland (2001: 34), for instance, claims that the proponents of the Washington Consensus "have faith in societal engineering" and "emphasise shrinking the size of government," without providing

specific references.<sup>41</sup> In fact, one of the points stressed by Åslund, Boone and Johnson (1996) is that rapid reforms encouraged institutional development in Eastern Europe. It seems thus that these authors were simply trying to answer a relatively narrow question of what economic policy moves were necessary for a successful transition, rather than trying to provide an encompassing list of *sufficient* conditions for such success. Their answer to that narrow question – which we may or may not accept – was that macroeconomic stabilisation and controlling inflation and government deficits were among those prerequisites that government could control.

What is important from our perspective is that although some important institutions were amenable to quick change by modifying the existing legal norms, most of them were subject to gradual change over which policymakers have only a limited degree of influence. Even those formal institutions that are seen as contingent on government fiat are dependent in reality on the presence of effective court systems, judges, and lawyers who are able to apply and enforce the new legal norms. Finally, the market economy is always embedded in a cultural framework, which depends on the prevailing norms sanctioning entrepreneurship, innovation, keeping promises, and so on. Economists and policymakers know little about the origin and evolution of these norms, and it would be presumptuous to claim that these can be tweaked at will.

In contrast, the narrower approaches to economic transitions, exemplified by Åslund, Boone and Johnson (1996), provided policymakers with a simple list of measures that had and could feasibly be adopted by policymakers in transitional economies that required immediate macroeconomic stabilisation, whereas the neo-institutionalist approach often asked politicians to pursue policies that were beyond their immediate control or understanding. A part of the appeal of the ‘shock therapy’ seems to lie in its focus on variables that policymakers could control directly – the statutory character of

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<sup>41</sup> Havrylyshyn (2001: 55), for instance, thus sees the characterisation of the Washington Consensus as oblivious to the importance of institutions for economic growth as mistaken.

private enterprise, legal restrictions on price formation and freedom of contract, and also on inflation, public spending and public deficits.

By the standards outlined in section 1.2 – and particularly if one appreciates the role played by tacit knowledge in society – it can be argued that neo-institutionalist reform prescriptions fared worse, notwithstanding their references to the intellectual tradition of Friedrich von Hayek.<sup>42</sup> Not only does neo-institutionalism require that policymakers are to identify the measures that are the most likely to elicit popular support in the beginning of the transition, but also that they are able to sequence the reforms in a way that would lead to the desired reform outcome. Even the question of identifying winners and losers from particular policy moves is a more complex task than first hits the eye. Counter-intuitively, Milanovic (1998) demonstrates that, in relative terms, the biggest winners of the post-communist transitions were pensioners who, because of their fixed pensions, experienced smaller declines in their real earnings than other social groups – a finding that is at odds with the popular perception of pensioners as the most vulnerable victims of the transition.<sup>43</sup>

While the insistence on experimentation and piecemeal change are reasonable, the success of a transition guided solely by these principles would require policymakers to design the optimal legal and institutional order for a market economy, while the economy was still in the shackles of bureaucratic control. Not only would such form of transition have problematic second-order effects – such as spontaneous privatisation of state-run enterprises<sup>44</sup> – but, more importantly, it would be impracticable because many of the institutions and norms guiding economic life are not known to anyone prior to the existence of the actual markets. Rapaczynski (1996) demonstrates that the progress in the creation of functioning and well-enforced property rights in transitional countries

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<sup>42</sup> Murrell (1993: 123).

<sup>43</sup> Hellman (1998), e.g., speaks of pensioners as of “traditional losers” of post-communist transitions.

<sup>44</sup> Unlike some proponents of gradualism who downplay the role played by spontaneous privatisation, Johnson and Kroll (1991) argue that spontaneous privatisation was a very real phenomenon.

could not be expected to come from a flawless ex-ante design of legal rules. In the case of more complex assets and more intricate market relationships, it is impossible to identify the desirable legal mechanisms in advance, without observing the practice that emerges on the markets.

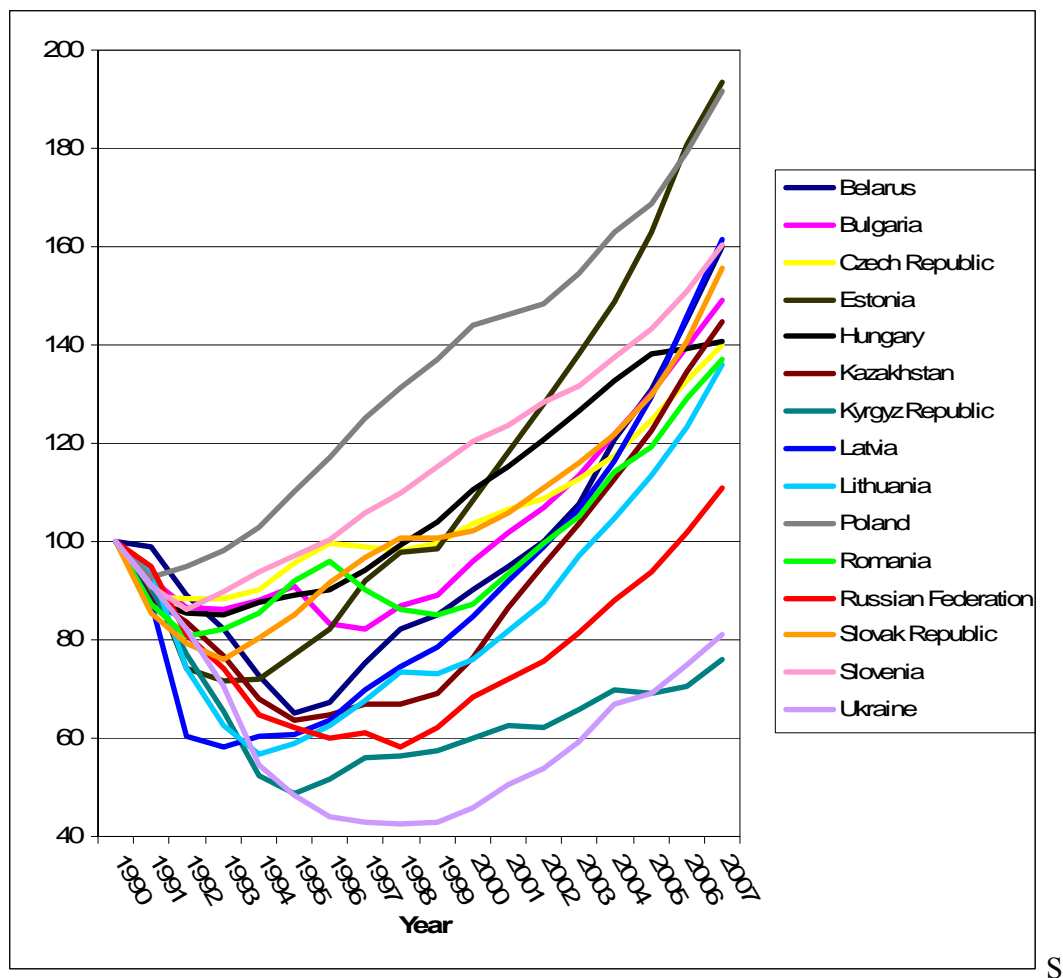
### **1.3.3 What does evidence tell us?**

Could the disagreement between advocates of shock therapy and those defending a more gradualist approach be reconciled by inspecting the economic performance of countries that followed different policy advice? The difficulties of such exercise are considerable, considering the complex nature of economic and political changes in Central and Eastern Europe in the 1990s. Transitions are a perfect illustration of under-identified problems, in which the number of potential explanatory variables exceeds the number of data points available, limiting the usefulness of conventional econometric tests.

This sub-section highlights several stylised facts related to transitions in Central and Eastern Europe and discusses the relative merits and demerits of gradual reform prescription and its more radical alternatives. In spite of its fall from favour among economists, in most places, it is not obvious that the relatively simple strategy of macroeconomic stabilisation, privatisation and liberalisation was associated with systematically worse outcomes than more gradualist strategies. Figure 2 below reports the economic performance of transitional countries since 1990 until 2007, a year before a financial crisis hit the Baltic states. By 2007, Poland, Estonia, Slovenia, and Latvia had made the most impressive recoveries from the output fall that had occurred in the early stages of the transition. It also shows that only a limited number of countries recovered their initial levels of economic output in the first decade of the transition; these included Bulgaria, Czech Republic, Estonia, Hungary, Slovakia, and Slovenia.

The chart also reveals a distinctly poor performance of Ukraine, Kyrgyzstan, and Russia, but in the initial phases of the transition, as well as in the 2000s.

Figure 2 Fall in output per capita in transitional economies between 1990 and 2000 (GDP per capita in 1990 = 100)



source: World Development Indicators, World Bank

Output in practically all of the post-communist countries followed a J curve, as the initial fall was later reversed by an upward trend. The initial slump was much deeper and the recovery was slower in the case of the post-Soviet space, with Russia recovering its 1989 output levels only as late as in 2006. In Central and Eastern Europe, 1989 GDP levels had been reached already at the end of the 1990s, and the upward trajectory was sustained until the Great Recession of 2008. As Shleifer and Treisman (2005) and Åslund (2002) point out, standard GDP statistics might well overestimate the magnitude

of the output fall, especially in a country like Russia where the 1989 output levels were likely overstated due to the high share of industry creating little or no consumer surplus, such as the military production sector.

A simple inspection of the data in Figure 2 does not indict shock therapy as the main driver of the slump. Countries where the initial slump was the smallest and which recovered most rapidly were Poland, Slovenia, Estonia and Hungary – countries that followed thorough reform strategies.<sup>45</sup> These were countries that had achieved, by 1995, the greatest progress in their transition towards a market economy, as measured for example by the set of Transition Indicators published by the European Bank for Reconstruction and Development. In contrast, on the graph the worst outcomes are recorded for Ukraine, Russia and Kyrgyzstan – countries that refrained from more radical reforms to their economies in the immediate aftermath of the fall of communism.

As Campos and Coricelli (2002) note, the fall in output was accompanied by a contraction in the capital stock. Socialist economies were characterised by inefficiently large amounts of capital. Furthermore, they had an interlocked structure of capital goods which could not be sustained on an open market and which could be reallocated towards uses in the emerging private sector at significant cost, if at all. Roland and Verdier (1999) provide an almost ‘Austrian’<sup>46</sup> account of this argument through a model of relations-specific investment, implying that new investments would occur only after new business relationships are formed. Interestingly, they blame rapid liberalisation for the resulting economic downturn, arguing that a more gradual privatisation, creating a two-track economy, with a parallel existence of private markets and a centrally planned system, might have avoided this outcome. However, the key point is that production

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<sup>45</sup> Admittedly, that does not necessarily mean that the countries followed ‘shock therapy’ in the strict sense. Hare (1991) and Hare et al. (1992) show there was a degree of continuity of early Hungarian reforms in the 1990s with the previous reforms attempted by consecutive communist governments.

<sup>46</sup> See, e.g., Horwitz (2000). See also Bevan et al. (2001) for a similar account, in which specificity of inputs led to greater output adjustments in more complex supply chains.

structures that did not reflect underlying consumer valuation were unsustainable on competitive markets. Therefore, unless the pro-reform governments were in a position to subsidise the loss-making state-owned enterprises, it was necessary to close them down, even at a sizeable social cost.

The collapse of the Council of Mutual Economic Assistance contributed to the fall in output. The ability of economies to reorient their trade towards the West was critical in coping with the slump.<sup>47</sup> The most agile adjustment occurred in the Visegrad countries and in the Baltics. Campos and Coricelli stress the remarkable speed of the reorientation of trade in Baltics: a rise of the share of exports to industrial countries as a percentage of total exports from five percent in 1991 to more than 50 percent in 1998. This adjustment was more difficult for many of the former USSR countries, especially those in Asia, for which access to Western European markets was extremely difficult, in part because of a lack of financial infrastructure and of foreign reserves, which were needed to support export-led growth.

These considerations suggest that post-communist economies clearly needed to undergo substantial structural changes, involving a reduction in the share of industry and growth of services. From this perspective, the claim made by Roland (2001: 44) that “standard (...) economics (...) at best would predict a low supply response to liberalisation but not a negative one,” is accurate only if one considers the simplest, the least sophisticated version of neoclassical models.<sup>48</sup> However, taking into account the heterogeneity of capital and complementarities that exist between different capital goods might go a long way in explaining this apparent paradox.<sup>49</sup> In any event, economies with worse initial conditions underwent deeper recessions.<sup>50</sup> But that does not mean that economic

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<sup>47</sup> Christoffersen and Doyle (1998) provide an early discussion of the importance of trade dynamics in transitions.

<sup>48</sup> Similarly, Blanchard (1997) characterises this slump as a puzzle since in his view the removal of distortions existing in socialist economies should have caused output to increase, not to decrease.

<sup>49</sup> Boettke (2003: 30).

<sup>50</sup> Heybey and Murrell (1999), Krueger and Ciolko (1998), Åslund, Boone and Johnson (1996).

policies were irrelevant for growth performance. A number of studies have found that greater liberalisation in the early years of the transition led to higher growth and lower inflation in the subsequent period<sup>51</sup>. One interpretation of that finding can be that fast liberalisation *works*. Obviously, a more cautious view is that countries with more favourable initial conditions were able to liberalise more quickly than others and also experienced smaller output losses. While adjudicating this dispute is not straightforward, it is difficult to find clear evidence that fast liberalisation was associated with deeper economic slumps in the 1990s.<sup>52</sup>

#### **1.3.4 Privatisation**

Rapid privatisation was among the most contentious aspects of the ‘shock therapy’. Some critics of privatisation argued that “rapid mass privatisation [...] was a crucial determinant of differences in adult mortality trends in post-communist countries.”<sup>53</sup> Although that claim has been shown dubious by further studies,<sup>54</sup> advocates of gradual reforms have suggested that privatisation was counterproductive because the institutions needed to underpin the markets were underdeveloped or absent prior to privatisation.

However, it is questionable whether those institutions could have emerged without privatisation. The idea that a complex legal and judicial framework, as well as a set of social norms, could have been imposed on a transitional country before any property rights were assigned, is not plausible if one adopts a perspective that stresses the emergent nature of institutions and the importance of local knowledge in social processes.

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<sup>51</sup> De Melo et al. (1996), Sachs (1996), and Fischer, Sahay and Vegh (1996), Åslund, Boone and Johnson (1996), Havrylyshyn, Izvorski, and van Rooden (1998) and Berg et al. (1999).

<sup>52</sup> This does not prevent Roland (2001: 45) from embarking on a speculation about the possible counterfactual to rapid price liberalisation. If the Chinese model of dual-track liberalisation was adopted, he claims, the output fall would have been only limited.

<sup>53</sup> Stuckler et al. (2009: 399).

<sup>54</sup> Earle and Gehlbach (2010), Gerry et al. (2010).



A large literature maps the effects of privatisation on economic performance. Harvylyshyn and McGettigan (2001) and Djankov and Murrell (2002) find that privatisation improved the performance of enterprises. Zinnes, Eilat and Sachs (2001) find that different countries react differently to privatisation. In itself, the privatisation of a company did not guarantee a genuine transfer of ownership. For that to occur, specific institutions needed to be in place. When privatisation occurred in good institutional environments, it had a positive effect on corporate performance. Conversely, however, Zinnes, Eilat and Sachs do not demonstrate a negative effect of privatisation on economic performance of enterprises when institutional conditions were adverse. However that may be, it is fairly obvious that not all privatisation methods led to the same economic outcomes. Hare and Muravyev (2002), for example, show that although substantial progress in privatisation had been achieved in the first decade of the transition in Russia, it was not followed by equally significant restructuring due the incentives facing the insiders who were involved in the privatisation process.

Meggison and Netter (2001) provide an encompassing literature review focused on the economic effects of privatisation, both in the developed world and also in transitional countries. The general conclusion is that privatisation “worked,” in the broad sense of improving firms’ performance. The paper singles out privatisation by insiders as problematic since it precluded value-enhancing exchanges. Looking at Central and Eastern Europe, the paper summarises a wide cross-section of empirical studies and notes that private ownership, especially foreign ownership, had large positive effects on firm-level performance and restructuring.

Nellis (1999) concludes his overview of privatisation in transitional economies by noting that in institutionally weak environments, privatisation has led to stagnation and decapitalisation of companies, instead of better financial results and increased efficiency. He stresses, however, that renationalisation or postponement of further

privatisation, was unlikely to provide any major gain. “Governments that botch privatisation are equally likely to botch the management of state-owned firms” (p. ix). Although privatisation in Central and Eastern Europe did not always live up to expectations, we have yet to see convincing evidence that its alternatives would have brought about significantly better outcomes – especially if we hold constant the underlying quality of institutions in different transitional countries.

To make a plan of gradual privatisation work, the managers would have to be incentivised to embark on a complex programme of restructuring before being accountable to shareholders. Not only is it unclear why they would do that if subjected to soft budget constraints, it is also equally unclear how they would gather the knowledge needed to restructure the companies in the appropriate way unless subjected to the discipline of profit and loss. To be sure, ‘stronger monitoring’ is often advocated as a solution to this problem. But unless the government can credibly threaten to close down the business in question – which is very unlikely in large parts of the state-run economy – such monitoring remains more of a wish than a policy option. Unless one makes heroic assumptions about the benevolence and knowledge of the enterprise managers and about the effectiveness of state control, it is unclear that a gradual privatisation programme would result in anything else but large scale rent-seeking and asset-stripping. Åslund, Boone and Johnson (1996) therefore describe this hypothesis to gradualist transition strategies as by-products of strong vested interests, which aim at capturing the state apparatus in order to keep the inflationary spigot running. Moreover, it appears that rapid privatisation– and privatisation with the participation of the general public – provided a political guarantee preventing reform reversal. The large scale of the newly created private sector and the mass character of the privatisation process, involving often the population at large as shareholders, could be seen as a constraint

against potential re-nationalisation. It is most likely harder electorally to go against the interests of many citizens-shareholders than against those of a few capitalists.

### **1.3.5 Did *mētis* matter?**

So far, this account of economic transitions in Eastern Europe has not employed explicitly the notion of cognitive constraints to policy making. However, as Chapter 5 of the thesis illustrates, differences in cognitive constraints can help explain some part of the variation in institutional and economic outcomes during post-communist transitions – although estimating their effect formally proves to be a challenge. Similarly, little systematic evidence exists that would link actual policy choices made by policymakers in transitional economies and prevailing attitudes or informal norms. However, the idea that differences in beliefs are associated with differences in aggregate economic outcomes underpins much of the recent work by Douglass North,<sup>55</sup> who had stated that:

‘[I]t is much easier to describe and be precise about the formal rules that societies devise than to describe and be precise about the informal ways by which human beings have structured human interaction. But although they defy, for the most part, neat specification and it is extremely difficult to develop unambiguous tests of their significance, they are important.’ (North 1990: 36)

A growing body of literature suggests that differences in institutions are associated with differences in beliefs and policy preferences displayed by individuals.<sup>56</sup> As mentioned earlier, Tella and McCulloch (2009) explain the joint incidence of leftist beliefs, heavy regulation and corruption. In their setting, leftist beliefs are endogenous to the experience of ‘unpleasant’ capitalists and serve as a mechanism that reinforces heavy regulation that encourages further corruption. Likewise, Tabellini (2010) identifies an

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<sup>55</sup> See, specifically, North (2007).

<sup>56</sup> Alesina and Fuchs-Schündeln (2005), Di Tella, Galiani and Schargrodsky (2007), Landier, Thesmar and Thoenig (2008).

empirical link between cultural norms and economic outcomes and shows that pro-individualistic and egalitarian cultures are associated with higher levels of economic development.

In the context of transitional countries, the bulk of the existing research has focused on the investigation of determinants of support for economic reforms.<sup>57</sup> The early evidence is aptly summarised by Rodrik (1996). The findings are generally in line with the theoretical work on barriers to economic reforms,<sup>58</sup> which suggests that uncertainty over distributional benefits of reforms generates a status quo bias, whereas the possibility of identifying the winners and losers opens door to mutually beneficial bargains. Relatedly, Rodrik (1994) develops a simple heuristic, the ‘political cost-benefit ratio’ which relates the efficiency gains from reforms to their political ‘costs’ in the form of redistribution of income away from groups that benefit from the status quo. In areas where the amount of redistribution to the efficiency gains generated is high, reforms will be particularly difficult.

On empirical grounds, some findings suggest that private entrepreneurs, white-collar workers and university-educated voters were generally supportive of the transition, whereas the unemployed, retirees, blue collar and agricultural workers opposed the reforms.<sup>59</sup> Similarly, scholars have investigated the sources of support for revising privatisation in transitional countries<sup>60</sup> or the effects of economic hardship on ideology and political attitudes.<sup>61</sup> Earle and Gehlbach (2003) find that receiving property through

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<sup>57</sup> See, e.g., Landier et al. (2008).

<sup>58</sup> Fernandez and Rodrik (1991).

<sup>59</sup> Fidrmuc (2000).

<sup>60</sup> Denisova et al. (2007).

<sup>61</sup> Večerník (1995).

restitution was strongly associated with support for economic reform and privatisation among those who were on the receiving end.<sup>62</sup>

In spite of the seeming importance of the subject, very little of the existing literature is focused on tracking systematic differences between countries or nations, or trying to explain those differences. Exceptions include the differences between citizens of the Soviet Union and the United States documented by Shiller, Boycko and Korobov (1991), the differences between former Soviet republics documented by Miller, Hesli and Resisinger (1994) or the wider Central and Eastern Europe documented by Rovelli (2009), Krkoska and Robeck (2008) or Runst (2012). Finally, Pejovich (2003) provides an overview of the mechanisms, illustrated by short case studies, of how cultural norms affected outcomes of the economic transition in different countries of Central and Eastern Europe.

The aim of Chapter 5 in this thesis is to argue that a link exists between popular attitudes and policy choices. While the perils of demonstrating such a link through formal econometric evidence are obvious, there are *prima facie* reasons to believe that in political systems relying on decision-making by popular majorities, the policies undertaken will have to reflect, in some broad sense, the attitudes, beliefs, norms and mental models prevailing in the society.

#### **1.4 Conclusion: What have we learned?**

This account of economic transitions in the post-Soviet world can be seen as a source of several insights that motivate the themes explored in this thesis. Most importantly, while the distinction between the Washington Consensus and the more gradual, neo-institutionalist approaches animated the debates of the 1990s, it was not particularly compelling. After all, very few participants of the debate would argue that the

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<sup>62</sup> Needless to say, restitution of property remained a contentious and politically sensitive issue throughout the transitional economies, and only a handful of countries, such as the Czech Republic, used it on a larger – albeit very strictly limited – scale.

institutions in which the emerging market economy was embedded did not matter for transitional outcomes. It is likewise obvious that different policies required different time frames for their implementation – certain measures could be taken immediately, whereas others required a long time to come to fruition. In our opinion, the relevant distinction was between approaches that appreciated the incentive-related and cognitive constraints facing policymakers and approaches that started with a relatively unconstrained vision of policy making. By this metric, both gradualism and the ‘Washington Consensus’ had different strengths, and failed at different margins.

The general lessons from the economic transitions in Central and Eastern Europe could thus be summarised as follows:

- (1) Successful reform strategies should focus on controllable variables, as opposed to factors that are out of policymakers’ reach;
- (2) Policymakers should focus on a small number of known and measurable variables, as opposed to a large number of complex variables, the interactions of which they might not fully understand;
- (3) Credibility matters. Successful reform strategies in transitional environments must be able to overcome the problem of a lack of credibility. Speed, completeness of changes, and their irreversibility seem to achieve that; and
- (4) Initial conditions matter. Besides differences in levels of economic development, institutional, legal and political legacies, transitional economies differed in the preferences, beliefs and mental models of the general public. It remains an open question to what extent the latter played a role in the transitions.

Each of these points opens a range of research questions. In the case studies that follow, we will focus specifically on points (3) and (4) – on how credibility problems affect

policy-making and institutional outcomes and how beliefs influence the success or failure of different reform strategies. This choice is not guided by deep theoretical reasons, but is a rather opportunistic reaction to the availability of interesting empirical material that one can study in this area. Some of this material comes, interestingly enough, from the economies of the Middle East and North Africa, which are currently undergoing significant economic and political changes. Besides studying the importance of policy credibility, this thesis will purport to substantiate the links between cognitive constraints – or *mētis* – and policy outcomes by studying the example of transitional Czechoslovakia in the 1990s. However, before proceeding with the individual case studies, Chapter 2 will lay down the fundamental methodological apparatus that guides our work in the remainder of the thesis.

## 2 Methodology

### 2.1 Introduction

This chapter provides an overview of the main methodological strategies used in the three case studies that form the core of this thesis. The case selection is arguably eclectic and, in some sense, opportunistic. We investigate two country-specific questions relevant for Egypt and post-communist Czechoslovakia, and one that is focused on a broader range of countries in the Middle East and North Africa. Our primary ambition was to produce self-contained case studies that can generate valuable insights on their own, yet which are connected to the theme of cognitive and incentive-related constraints affecting policymaking and reform processes. Instead of committing upfront to a specific geographical or historical focus and developing it into a long-form book project, which tends to be common in some parts of this stream of literature, we have opted for three self-contained case studies, directly publishable as articles in peer-reviewed journals. These case studies attempt to illustrate the substantive points that are of interest to us: the effects of credibility problems on policymaking and on the structure of the political landscape, as well as the role of *mētis* in shaping economic policy. These studies could be scaled up, with the addition of further research material into a book project. The other factor that motivated our choice of specific case studies is intellectual product differentiation. It is striking that a dominant part of the literature both in economics and political science that discusses durability of reforms, reform reversals, and political economy of legal and institutional change focuses on the experience of the United States and of the developed world. One reason is related to the relative abundance of high quality data. However, transitional countries of Central and Eastern Europe, as well as poorer parts of the world, such as the Middle East and North Africa, can offer unexpected sources of variation, even though exploring them may



involve eschewing some of the traditional statistical tests in favour of more unconventional methods, such as analytical narratives.

The thesis is further distinguished by its use of case studies and analytic narratives as the main tools of analysis, as opposed to cross-country quantitative evidence. Analytic narratives represent an approach that aims at connecting rational choice-based models with traditional narrative explanations of phenomena in the social sciences, revolving around the questions of political order and institutional change.<sup>63</sup> Chapters 4 and 5 present also formal, quantitative evidence. However, the identification issues involved, as well as the coarse nature of the existing survey-based data, which are relevant to our enquiries, would make an exclusive reliance on econometric evidence unduly limiting. The analytic narratives used throughout the thesis are therefore offered as complements to the more orthodox methods of quantitative enquiry used in economics.

Simultaneously, this thesis is characterised by a relative absence of formal theory. Chapters 3 and 4 present stylised verbal models from which testable claims are derived but the thesis offers little in terms of the formal modelling that is common in contemporary political economy.<sup>64</sup> Given that this collection of papers is not seeking primarily to make a theoretical contribution, it is unclear what benefits formal modelling would have for our purposes. The toolbox of models and theoretical propositions that are used throughout this thesis is not novel – rather, the point of the exercise is to see how well it can account for some of the notable patterns in the design of economic reforms and their success, as well as in policy-making in transitional political environments. It should be stressed that our approach is by no means atheoretical. Throughout the thesis, a core assumption of individual rationality is maintained, although our core claims are driven not by strict assumptions about individual rationality, as is often the norm in orthodox microeconomic modelling, but

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<sup>63</sup> See Bates et al. (1998).

<sup>64</sup> For an introduction, see, e.g., Persson and Tabellini (2002) or Besley (2007).

rather by the interaction of rational, purposeful behaviour with existing institutions. In that sense, the thesis displays a commitment to the agenda of classic public choice analysis, institutional analysis, and Austrian economics – which could be subsumed, following Boettke (2012), into the notion of ‘mainline economics.’

With the exception of Chapter 5, which has a more explicitly descriptive character, the dominant approach throughout this thesis consists of an articulation of simple rational choice-based verbal model, from which various testable implications are derived and compared against observed reality. This is done either informally or through the use of formal, quantitative evidence. Given the substantive focus of our thesis, surveys, including Arab Barometer, Eurobarometer, and Economic Expectations and Attitudes, a survey run in the Czech Republic and Slovakia in the 1990s, represent the main sources of formal data.

Surveys are useful for our purposes because they provide the most straightforward measures of beliefs – and potentially of *mētis*. True, cross-country data may not be comparable because of the specific wording might carry different meanings in different contexts.<sup>65</sup> Furthermore, people can lie, if we have reasons to believe that they misrepresent their beliefs and preferences in a systematic way. In authoritarian regimes, for example, respondents face incentives to misrepresent reality in a way that is congruent with the official line of the government or of the ruling party.

An important limitation in this thesis has to do with the quality and relevance of the used survey data. Not all attitudes that are of interest to us have been articulated in surveys; and those that have been have often been translated into questions that are imperfect for our purposes. Moreover, the finite nature of surveys implies their potential incompleteness – one can only get answers to questions they have asked, and there are

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<sup>65</sup> See also Di Tella and MacCulloch (2006) for a discussion of survey data in the context of well-being research.

only so many questions that one can ask within a survey.<sup>66</sup> Unless individuals are asked about specific beliefs and preferences, those may go unnoticed. Conversely, questions on subjects about which individuals have not thought or sufficiently cared about might elicit opinions that they do not hold strongly.

The remainder of this chapter presents detailed accounts of methodological strategies employed in the three subsequent case studies.

## **2.2 Methodology of Chapter 3**

Chapter 3 represents perhaps the most straightforward case study in this collection of essays. In order to explain the persistent failure of reforms of Egypt's system of subsidies, we build a verbal model of policy credibility and present a theoretical account of mechanisms that facilitate commitment of policymakers to efficiency-enhancing reforms. We then discuss whether these are present or absent in Egypt. The chapter has also a descriptive part, synthesising information about Egypt's subsidy system, its operation and its history.

The explanation of the Egyptian reform failure then proceeds by investigating whether such mechanisms are present or absent in the Egyptian context, establishing that prospective reformers in Egypt are facing deep commitment problems. Furthermore, we outline several other plausible explanations of the phenomenon of reform failure and demonstrate that these fail to account for important aspects of the Egyptian reality. Finally, we derive several immediate lessons that seem of importance for public policy. These are discussed in Chapter 3, as well as in the conclusion of this thesis, in Chapter 6.

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<sup>66</sup> Or, '[t]he fundamental problem is that the dimension of the vector of institutions that we believe influences growth is extremely large.' (Pande and Udry 2005: 5)

## 2.3 Methodology of Chapter 4

This chapter provides a rational choice-based explanation for the popularity of Islamic political groups in countries of Middle East and North Africa – most notably in the countries of the Arab Spring. The central argument is built on a simple verbal model of credible commitment and patronage, complemented by an account of organisational properties of religious groups, referencing the sizeable literature in the field of economics of religion. This discussion yields a number of testable implications. Whilst some of them can be compared against reality directly, others require a more intricate statistical test.

One question that does require a formal, statistical test is whether political Islam is connected with any consistent pattern of policy preferences in the Downsian policy space, or an ‘Islamic ideology.’ Using data from the 2006-2007 Arab Barometer,<sup>67</sup> which covered Jordan, Palestinian territories, Morocco, Algeria, Lebanon and Yemen, we provide a *tentative* answer to that question. We put the emphasis on the word ‘tentative’ because the data which we have at our disposal are far from perfect for answering the query that interests us. For one, the selection of countries offers only a very imperfect overlap with the countries of the Arab Spring, leaving out Egypt, Tunisia, Libya, and Syria, and including countries that are not currently undergoing significant political changes, such as Jordan or the Palestinian territories. The justification for our approach is mainly instrumental. Even if the test we can offer is far from the ideal test to which we would like to subject our hypothesis, it is still extremely informative. Should religiosity be a significant predictor of policy preferences across the Arab countries covered by the survey, the central claims made in Chapter 4 would seem much weaker and much less convincing.

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<sup>67</sup> Tessler et al. (2008) also use the Arab Barometer data to test various hypotheses about voting behaviour in the Arab world.

Our right-hand side variables are twofold. Firstly, we use the individual preferences over essential characteristics of democracy expressed in the survey. Respondents were asked to choose from the following four attributes: (1) opportunity to change the government through elections, (2) freedom to criticise the government/those in power, (3) a small income gap between the rich and poor, and (4) basic necessities like food, clothing and shelter for everyone. Secondly, we look at individuals' assessment of how well or badly is their government doing on a variety of matters, ranging from the economy, through to education and health, to addressing deteriorating morality (247q). The respondents are also asked whether human rights violations are acceptable if justified by security or stability concerns (234q). Finally, respondents are given a choice of various issues and are asked to choose the one that they perceive as the most important problem facing their respective countries (withoutPalestine248q).<sup>68</sup> All of the dependent and independent variables are listed in Tables 9 and 10 in the appendix. To measure a preference for political Islam, we use the first principal component of four variables, related to the role of Islam in politics (*Political Islam*). These variables are described in Table 10. Following the standard practice, we retain only the first principal component because it is the only one with an eigenvalue greater than 1. Table 11 in the Appendix reports the factor loadings and unique variances for this principal component. We have reversed the sign on the *Political Islam* to ensure that *higher* values of *Political Islam* can be interpreted as *higher* degree of political Islamism. Besides this composite variable, we include a vector of country fixed effects and standard individual characteristics, including the level of civic engagement.

Following standard practice in this area of research, we estimate the relationship between *Political Islam* and policy preferences – controlling for a vector of potentially

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<sup>68</sup> The poll asks a modified version of the question, with different options, in Palestine as well, (onlyPalestine248q) so in principle a separate regression could be run on Palestinian data alone. We have decided to eschew that in this version of the paper because the development in the Palestinian territories is not central to our argument and because it would be impossible to compare the results with the regression run in other Arab countries.

relevant explanatory variables – using ordered logit regressions,<sup>69</sup> the results of which are reported in Tables 12-14 in the appendix. A detailed discussion of the results can be found in section 4.3.2.1.

## **2.4 Methodology of Chapter 5**

Chapter 5 relies on econometric evidence establishing the existence and significance of differences in beliefs about markets and policy preferences between the people living in the Czech part and the Slovak part of Czechoslovakia in the early 1990s. This evidence is then complemented by a historical narrative that finds that these differences had their counterparts in the realm of actual policy platforms that dominated the political scenes in the Czech Republic and Slovakia.

The data for the first stage of the investigation come from the survey *Economic Expectations and Attitudes*, run by the Institute of Sociology at the Czechoslovak Academy of Sciences from 1990 until 1998. The early waves of the survey (until 1994) covered both republics; after the split, the survey provided data only for the Czech Republic. We use only the data from the first six waves of the survey, in the period between 1990-1993. Each wave provides roughly 1,600-1,700 observations, leading to a total of over 10 thousand data points in the sample under consideration. The survey uses quota sampling to cover a representative sample of the Czechoslovak population. In the first stage, stratification by settlement size and region is used, and then, in the second stage, respondents are selected by quota sampling by age, gender, and education.

The survey asked questions about people's perceptions of the changes that the country was undergoing, their views on different economic policies, and broader questions about social justice and the role of the government in the economy. While the survey asks a large variety of questions about economic and social policies, economics, trade,

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<sup>69</sup> The choice of logistic regression in this case should not be a matter of great controversy; in any event, alternative estimation procedures (OLS, probit) yield results that are qualitatively similar.

entrepreneurship and inequality, not all of the questions are covered in all years of the survey. Furthermore, many of them are substantively ‘collinear,’ which decreases the value of analysing all of them in great detail.

We have settled on six questions that in our view capture important dimensions of economic and social policy in the aftermath of the fall of communism – ranging from broad questions about the desirable economic system to specific queries about social policy, privatisation and health care – and which have the widest coverage throughout the different waves of survey.

The first question, *Money For Competent*, asks whether “[i]t is right that capable and competent people have a lot of money, even millions.” Answers to this question can be potentially informed by the respondents’ beliefs about meritocracy and their preference for egalitarian distribution of resources.

The second question, *Unnecessary Job Positions*, asks whether respondents agree with the statement that “[u]nemployment should be prevented even at the cost of preserving many unnecessary jobs.” Answers to this question can reflect individual preference for job security. Relatedly, the third question, *Transform SOEs*, asks whether “[a]ll big state enterprises should be transformed into shareholders’ companies or private firms.” Answers to this question are likely related to the individuals’ views of corporatisation and privatisation of the state-run economy.

Fourthly, *Only Capitalism* asks whether “[c]apitalism represents the only possible course of our future development.” Clearly, this is a broad and somewhat vague question, but the answers plausibly reflect the ideological positions of respondents and their beliefs about the desirable path for the economic transition.

The fifth and the sixth question, *Private Social Services* and *Private Health Care*, ask about the respondents’ attitude toward the privatisation of social services and health

care. The exact wording of the questions is as follows: “Would it be right, according to your opinion, that a part of social care, e.g. care for the elderly, would be performed by private institutions?” and “would you agree with the introduction of private medical care?”

Data reported in the *Economic Expectations and Attitudes* provide us also with control variables with individual characteristics including age, educational status, income, self-reported ideology, and so on. Later in this chapter, we also exploit the variation in regional characteristics, such as employment structure by sector, or various historical features. A summary of the variables used is reported in Table 16 in the appendix.

For the questions 1-5, the answers are coded as follows: 1 definitely no, 2 rather no, 3 rather yes, 4 definitely yes. For question 6, we recoded the answers so that being pro- or anti-market results in the same sign as in the case of the other variables. The answers to the question of *Unnecessary Job Positions* is thus coded as follows: 1 definitely yes, 2 rather yes, 3 rather no, 4 definitely yes

To investigate whether differences exist between policy preferences of the Czechs and the Slovaks, we first run simple univariate ordered logit regressions. These reveal that the differences in observed means are statistically significant. Afterwards, we investigate whether the observed differences are simply artefacts of the underlying differences in socioeconomic status between the Czechs and the Slovaks. The results of these regressions are reported in Table 6 in Chapter 5. Our estimation strategy relies on a large number of categorical variables. In such circumstances, ordered logit could produce inconsistent estimates unless the number of observations in each category is large.<sup>70</sup> While this concern may not be hugely consequential in this context, as the observed differences between logit estimates and its alternatives are not large, we report the results that rely on the use of linear probability models (i.e., OLS). In the next stage

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<sup>70</sup> Greene (2008: 805).



of this econometric exercise we attempt to explain whether the differences in opinions between the Czech and the Slovak population could be explained by measurable differences in various structural and historical characteristics. Obviously, the measures that we have been able to use are very coarse and the results need to be taken with a grain of salt. Nevertheless, inserting these alternative ‘explanations’ into our regressions one by one, and using them to produce a joint test of significance, does little to displace the *Slovak* dummy, although it does reduce its size somewhat.

To complement the evidence of sizeable and statistically significant differences in self-reported beliefs between the Czechs and the Slovaks, Chapter 5 also presents a historical narrative of the period following the fall of communism in Czechoslovakia to the split of 1993. We note that significant differences existed between the composition of Czech and Slovak political elites who formulated the initial transition strategy and while Klaus’ plan of radical reform resonated in the Czech context, Slovak politicians seemed inclined to prefer more cautious, gradualist policies. These differences were reaffirmed in the election in 1992, which brought two leaders with incompatible policy visions to power in the Czech Republic and Slovakia.

The evidence that we present in Chapter 5 obviously suffers from a identification issues that prevent us from claiming that the differences in beliefs were a cause of the split of Czechoslovakia and of the different transitional paths of the two countries. The differences in beliefs may have simply reflected differences in the expected cost of the rapid transition – after all, the initial output slump was deeper in Slovakia than in the Czech Republic, as documented on Figure 1. The differences in beliefs could have also been a reflection of Slovak nationalism, of the discontent with the constitutional arrangements in the common state, or of the personal appeal of Vladimír Mečiar. If that were the case, the observed differences in beliefs could have followed the different policy decisions in the two constituent parts of Czechoslovakia, without exercising any

causal effect on those decisions. Our hope is that by documenting the existing differences in opinions and by showing that they were perfectly aligned with the differences in policy decisions, we have provided an impetus for further research into this question.

### 3 Policy Credibility and the Political Economy of Reform: the Case of Egypt's Commodity Subsidies<sup>71</sup>

#### 3.1 Introduction

In settings with well-defined property rights and low transaction costs, economists expect private actors to eliminate inefficiencies through competition or through bargaining. Why doesn't the same reasoning translate easily into the political realm? How can we account for the emergence and persistence of institutions and policies that entail large social losses? A sizeable public choice literature explores the failures of the political process to generate efficient outcomes, starting with Tullock's (1967, 1975) seminal contributions. However, disagreements exist over the mechanisms through which the political process prevents efficiency-enhancing political bargains from occurring – including most prominently transaction costs,<sup>72</sup> rational ignorance,<sup>73</sup> problems of credible commitment,<sup>74</sup> to a failure of individual rationality in the political realm.<sup>75</sup> The latter class of explanations would include accounts that rely on sources of independent variation in beliefs – or in *mētis* – as the key moving force determining social and economic outcomes.

To elucidate that question, this chapter provides a case study of failed subsidy reforms in Egypt. In 2012, close to one third of the country's public spending – or 13 percent of GDP – was directed towards subsidies of consumer goods, ranging from diesel oil to tea. Besides the fiscal burden, subsidies disproportionately benefit the wealthier segments of the population, which makes them ill-suited as instruments of social assistance. They distort the supply of commodities and deter entry, resulting in poor quality and unreliable service. Subsidies also invite arbitrage, leading to leakages to

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<sup>71</sup> A version of this chapter is forthcoming in *Journal of Institutional Economics* (Roháč 2013a).

<sup>72</sup> Tullock (1975).

<sup>73</sup> Downs (1957).

<sup>74</sup> Rodrik (1988), Keefer and Vlaicu (2008).

<sup>75</sup> Caplan (2007).

black markets and to smuggling.<sup>76</sup> Yet, subsidies are embedded in Egypt's political landscape as the main tool of redistribution. Attempts to reform the subsidy system in the past were met with popular resistance.

According to this chapter, the lack of credibility can explain why subsidies have withstood reform. Therefore, it is not necessary to try to explain the apparent inefficiency of the Egyptian subsidy system by an appeal to particular characteristics of Egyptian political culture, belief system, or *mētis*. The costs of reform reversal and the costs of opportunistic seizure of the surplus of a reform – typically in the form of budgetary savings – by politicians have been low in Egypt. A premise of our explanation is that the public expect that any savings from a subsidy reform would end up being grabbed by the political elite and its cronies instead of being directed at the population, either in the form of a lower tax burden or increased provision of public goods. As a result, the government has never been able to commit credibly to a permanent reform of subsidies. Instead, only marginal changes have been enacted occasionally and then reversed. In the pre-Arab Spring Egypt, the costs of reform reversal were low because the one-party system provided very few genuine veto players that could block such policy reversals. Even after 2011, Egypt's politics suffered from credibility problems as well because, in general, new politicians in new democracies cannot easily make credible pre-electoral promises about policies.<sup>77</sup> As a result, problems of credible commitment in policy making will likely plague Egypt regardless of how oblique is the country's journey towards an open political system.

This chapter provides a discussion of how the lack of credibility could be overcome by appropriately designed reforms. In order to overcome the credibility problem, a reform of subsidies would need to be quick, irreversible and simple to implement. It should also involve an explicit mechanism for distributing the gains of the reform and be

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<sup>76</sup> Pelham (2012).

<sup>77</sup> Keefer and Vlaicu (2008).

accompanied by complementary measures that would yield wide benefits to the population and improve the functioning of the markets for food and energy.

This chapter fills gaps in several streams of literature. Firstly, it represents a new application of the research on policy credibility<sup>78</sup> to a problem that has obvious relevance for policy in low- and mid-income countries. Its purpose is to provide an answer to the question asked often by public choice theorists – namely, why do efficiency-enhancing trades often fail to materialise in the political realm?<sup>79</sup> Besides commitment and credibility problems, the existing literature cites the impracticability of compensation schemes that would accompany changes in policy,<sup>80</sup> uncertainty over distributional effects of policy changes<sup>81</sup> or a status quo bias driven by incentives.<sup>82</sup>

Secondly, the paper represents an addition to the literature on the evolution of policy and durability of reforms, which has so far focused mostly on the American context<sup>83</sup>, and much less on low- and mid-income countries, or transitional economies.<sup>84</sup> Poorer parts of the world, however, by offering a greater variation in policies and economic outcomes, both over time and across countries, represent a natural testing ground for different models of policy persistence. Moreover, as we have seen in Eastern Europe in the 1990s, political and economic transitions tend create an environment in which many of the problems affecting political decision-making are exacerbated. That applies particularly to the problems of credible commitment and to the incentive-compatibility of economic reforms.<sup>85</sup> As a result, during post-communist transitions, wholesale and

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<sup>78</sup> Keefer and Knack (2007), Keefer and Vlaicu (2008), Coyne and Boettke (2009), Frye (2004), Talercio (2004).

<sup>79</sup> See Acemoglu (2003).

<sup>80</sup> Tullock (1975).

<sup>81</sup> Fernandez and Rodrik (1991).

<sup>82</sup> Coate and Morris (1999).

<sup>83</sup> Patashnik (2000, 2003, 2008), Maltzman and Shipan (2008), Berry, Burden, and Howell (2006), Moe (1989).

<sup>84</sup> E.g. Campos and Esfahani (2000), Frye (2004).

<sup>85</sup> Boettke (1995).

rapid reforms seemed associated with better outcomes than piecemeal changes<sup>86</sup> – in line with the logic of Rodrik's (1988) idea of overshooting as a signal of credible commitment. What is more, gradual reforms were often a by-product of strong vested interests that captured the state apparatus in order to keep the inflationary spigot running.<sup>87</sup>

The existing literature on reform durability has focused heavily on institutional settings in which reforms are adopted, as well as the nature of coalitions adopting such policies. By adding an explicit emphasis on policy credibility, it is hoped that this approach provides a more complete account of reform reversals than the ones commonly used in the literature. Finally, this chapter makes a connection between the political economy of credible commitment and the sizeable literature on subsidy reforms<sup>88</sup>, where an explicit political economy focus is underplayed and where the problem of subsidies is represented as a technical one. Although the technical aspects of subsidy reforms are without any doubt important, the goal of the paper is to focus the attention of researchers and policy practitioners on the broader issues of political economy of reform.

### **3.2 Reform reversals, reform paralysis, and lack of credible commitment**

Economic policies can be seen as contracts between politicians and a decisive part of the population, needed for the politicians to control of the government. Through such contracts, politicians obtain the support that enables them to control the government apparatus, in exchange for policies that deliver benefits to the part of the population that

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<sup>86</sup> Roháč (2013d), see particularly Figure 1.

<sup>87</sup> Åslund, Boone, and Johnson (1996)

<sup>88</sup> IMF (2013), Vagliasindi (2012), World Bank (2005), Coady et al. (2010), or Commander (2012).

is needed to control the government. As with other contracts, these are vulnerable to situations when politicians face incentives to deviate from the announced path.<sup>89</sup>

A substantial part of the population derives net benefits from the existing subsidy system, even though these come at a deadweight cost. Disturbing the status quo by eliminating subsidies would impose cost on that part of the population, even though it would enhance economic efficiency. An elimination of subsidies does not necessarily imply that ordinary Egyptians will receive the surplus, either in the form of lower taxes or directed transfers. Instead, politicians may choose to appropriate the surplus created by the reform to themselves. To elicit support for reform, politicians must propose an explicit – and credible – mechanism for distributing the benefits of the reform, which would leave a decisive part of the population no worse off than in the absence of reform. Even if a deal is reached, the public will have only imperfect mechanisms for monitoring politicians' compliance with their proposal and penalising them if they fail to deliver.

However, the negotiations and calculations needed to make sure that the decisive part of the population is left no worse off are costly and take time. That, together with competing demands on politicians' time and attention, can create a situation in which the surplus that politicians expect to appropriate from the policy change is outweighed by the costs of reaching a deal with the population.

Because the deadweight cost of a subsidy system extends over time, the benefits from the reform will not be realised all at once. Those who consent to the reform will have to rely on a promise made by the politicians to share with them the benefits from the reforms as they accrue over time. Such promises can be broken because, at a later stage

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<sup>89</sup> For different formulations of this problem, in different contexts, see Coyne and Boettke (2009), Keefer and Stasavage (2001), or Weingast (1997).

of the game, politicians may decide to redistribute the surplus from the reform opportunistically, violating their prior agreement with the population.

The situation is visualised on Figure 1 in Chapter 1, which mirrors the exposition in Coyne and Boettke (2009: 6). In the first stage of the game, the politician proposes a welfare-enhancing reform – i.e. an elimination of wasteful subsidies. In the second stage, the public decides whether to support the politician's platform or not. If the platform is rejected, both the politician and the public receive a default pay-off of 1, corresponding to the status quo. If the public supports the platform and the politician is elected, the politician has the option of either delivering on their promise, generating a pay-off of 2 to the politician and a pay-off of 4 to the voter. If the politician chooses to renege – e.g. by seizing the whole surplus from the reform – they will end up with a pay-off of 6, leaving the public with a pay-off of 0.

In a one-shot game, the outcome (Supports, Delivers) is not attainable because in the final stage of the game the politician is tempted to hijack the surplus created by the reform by reneging, creating a classic time inconsistency problem. Time inconsistency in multi-stage game is a situation where a player's best plan for some future stage of the game will not be optimal when that future stage arrives. A time-inconsistent game is subgame imperfect. The importance of time inconsistency in economics and in political economy was popularised through the work of Kydland and Prescott (1977), who developed an influential model of time-inconsistent monetary policy, and expanded through the seminal contribution of Rogoff (1985).

A rational public will reject the politician's reform proposal, resulting in an equilibrium that leaves room for a Pareto improvement, which is unattainable unless the structure of the game is changed in a way that precludes the politician from reneging in the final stage or makes reneging costly for him. The politician needs to find a way of making a credible commitment. The only subgame perfect equilibrium in the game is the one in



which the public rejects reform, leaving both the public and the politician with a lower pay-off compared to the Pareto superior outcome that the reform would have brought if implemented.

While the situation depicted on Figure 1 describes a one-shot game, it is possible to extend its implications to a dynamic environment. It is possible to imagine that the continuation of a subsidy reform over time requires a repetition of the game above in each period. Even if the initial problem of reform implementation is overcome and the politician delivers, it is not clear that he will continue delivering in subsequent stages of the game. The government can be changed in an election and the commitment of new politicians to delivering may be in doubt. That would induce the public to play 'Reject' in the following stage of the reform, leading to a repeal of the reform.

As Campos and Esfahani (2000) note, different mechanisms exist that can help politicians overcome such credibility problems. The general mechanism through which these mechanisms work is by decreasing the pay-off to the politician of seizing the surplus of the reform in the final stage of the game. The main testable prediction of this theoretical framework is that reforms will be more difficult if these commitment mechanisms are weak or unavailable.

### **3.2.1 Gains sharing**

A large part of the efficiency gains generated by the subsidy reform will in the form of budgetary savings. As a result, politicians will have discretion over the distribution of that part of the surplus. The main risk of the reform from the public's perspective is that the savings will be appropriated as rents by politicians. One way of overcoming that problem is for the politician to accompany the subsidy reform with a reduction of the tax burden, which would ensure that the savings are appropriated by the population. Alternatively, the government can create an explicit system of cash transfers that would

direct a large part of the budgetary savings to the population, conceivably in a way that targets poor households rather than wealthy ones.

Tax cuts and the creation of a system of transfers both have the potential to create constituencies who will derive benefits from the new status quo, who will have stakes in the reform and who will oppose its reversal, making it more difficult for the government to repeal the reform or seize the welfare gains that the reform would generate. It would do so by changing the structure of the pay-off in the final stage of the game depicted on Figure 1. The politician would no longer have the option of reneging at no cost and capturing the surplus of 6, leaving the public with a pay-off of 0. Instead, the politician would have to propose a statutory repeal of the tax changes or of the compensatory mechanisms accompanying the subsidy reform – which would hardly command popular support.

### **3.2.2 Governance reforms**

The subsidy reform may also be linked to governance changes that increase the cost of reform reversals. Such reforms may increase the number of potential veto players whose agreement is needed to revoke the reform, thereby making reneging on reform more difficult, enhancing thus the credibility of the reform. That can be achieved, e.g., by delegating the decisions over pricing of commodities to an independent regulator, instead of keeping them in the hands of the politicians. In other words, such governance changes would remove the power of politicians to renege in the final stage of the game by placing the node of decision-making into the hands of an independent regulator who does not face the same incentive structure and is unable to appropriate the created surplus for herself.

The costs of reversal can be increased by dismantling the administrative capability of the government to provide subsidies by closing down the relevant parts of the government apparatus. Precedents for such reforms include the abolition of foreign

exchange controls in the United Kingdom in 1979, when the relevant bureau of Bank of England was closed down, or the shutdown of the planning offices in Central and Eastern European countries in the early stages of the transition in the 1990s. In a case where subsidy systems have co-existed with heavy regulation of entry, it is plausible that the elimination of government-protected monopolies and opening up of markets to competition would make reintroduction of subsidies or price controls more difficult or perhaps even plain impossible.

### **3.2.3 International agreements**

Governments can use international treaties as a way of committing to certain policies. International treaties, or arrangement with organisations such as the European Union, World Bank or the International Monetary Fund (IMF), can offer substantial benefits to the governments. If they are conditional on governments' pursuit and upholding of subsidy reforms, the costs of reneging for the government increase.<sup>90</sup> This mechanism would change the pay-off structure of the game by imposing costs on politicians for reneging in the final stage of the game depicted on Figure 1 and therefore decreasing the pay-off from reneging or from seizing the surplus. An obvious limitation of such arrangements is that they do not extend indefinitely over time. Once a particular structural adjustment programme of the IMF is completed, it will no longer prevent the government from reintroducing inefficient price subsidies.

### **3.2.4 Reputation**

Politicians may use their reputation and their record of delivering on other policy-related promises to overcome the time inconsistency problem involved in removing subsidies. Politicians who have built a reputation for delivering on their promises will find it more costly than others to renege, and will be less likely to do so. Unlike the previous commitment mechanisms, this would not change the structure of the game

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<sup>90</sup> On this point, see Fang and Owen (2011).

directly. Instead, this mechanism would give voters an opportunity to punish the politician in subsequent rounds of the game.

This mechanism exists only in competitive political environments where citizens can vote politicians out of office and is available only to politicians who have a record of delivering on promises. Furthermore, it requires a political environment in which it is possible to track politicians' promises and monitor their performance. In other words, reliable channels of communication and feedback between politicians and the public must be established and the voters need to be able to gather information about the conduct of politicians. Such mechanisms, including free press<sup>91</sup> and institutions of civil society, may not be available in closed or uncompetitive political systems, and should not be taken for granted in new democracies either.

### **3.3 Egyptian subsidy system**

The origins of Egypt's subsidy system can be found in the combination of weak institutions characterised by a lack of capacity to direct transfers to vulnerable groups, and a demand for redistribution from the general public.<sup>92</sup>

This chapter takes a narrow understanding of subsidies as measures “that keep prices for consumers below the market level or keep prices for producers above the market level or that reduce costs for consumers and producers by giving direct or indirect support,”<sup>93</sup> in contrast with their broader understanding which may also encompass tax subsidies, cash subsidies or transfers in kind. The economic effects of subsidies are straightforward. By imposing a price below the market clearing one, policymakers create shortages.<sup>94</sup> In response, governments intervene to increase the total supply of the commodity. For example, to keep the subsidised bread available, the Egyptian

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<sup>91</sup> For a discussion between free media, institutional change and economic development, see Coyne and Leeson (2009).

<sup>92</sup> Commander (2012).

<sup>93</sup> De Moor and Calamai (1997:1), cited in Fattouh and El-Katiri (2012: 11).

<sup>94</sup> See Schneider (1988) for a basic framework for the microeconomic study of food subsidies.

government provides subsidised wheat flour, which it either buys on the world market or is involved in producing.<sup>95</sup> Subsidies also create opportunities for arbitrage, especially if private markets exist on which the commodities in question are traded at unsubsidised prices.

Given these inefficiencies, why is it that the subsidy system in Egypt has been so difficult to reform? The stylised model presented in Section 2.2 predicts that reform will be impossible to implement – or reversed later – if politicians do not have access to relevant commitment devices or when those devices are weak. All four of the following commitment devices have been either absent or weak in the Egyptian context: (1) gains-sharing schemes accompanying the attempts at reform, (2) independent regulatory structures constraining the power of politicians to reintroduce subsidies, (3) international treaties or conditional arrangements with international organisations, (4) politicians who would use reputation on competitive political markets.

### **3.3.1 Background**

After World War I, the Egyptian government started importing large quantities of wheat and selling them at subsidised prices in government-owned shops.<sup>96</sup> World War II led to the introduction of rationing of basic commodities, including wheat and sugar. After independence, subsidies of food, transport, housing, energy, water and health – and also to soap and cigarettes – became an essential element of the relationship between the government and Egypt's citizens. The agrarian reform of 1952 was a catalyst in that process and led to a direct involvement of the government in numerous aspects of food production and distribution.<sup>97</sup> Rationing was used, then removed, and finally reintroduced in 1966.

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<sup>95</sup> In 2010/2011, 70 percent of the high-extraction flour used in the production of coarse *baladi* bread was produced by the public sector. Also, the public sector purchased roughly 61 percent of the total wheat imported to Egypt. (Mansour 2012)

<sup>96</sup> See Ghoneim (2012: 5-7) or Ahmed et al. (2001: 5-12) for a history of Egypt's food subsidy system.

<sup>97</sup> Gutner (2002: 461).

Table 2 provides information about the size of subsidy spending relative to the Egyptian public spending. Subsidies to petroleum products account for almost three quarters of the total spending on subsidies. The remainder is directed towards spending on food subsidies, most notably bread. While the relative size of subsidy spending has fluctuated as a result of a growth in other areas of public budgets, spending on subsidies, expressed either in Egyptian pounds or US dollars has grown continuously since the fiscal year 2005/2006.

Table 2 Spending on selected subsidies (% of total spending)

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/2013
Food	8.14	4.24	5.83	5.99	4.60	8.15	6.43	5.53
(GASC) <sup>1</sup>								
Petroleum	36.16	18.07	21.34	17.84	18.18	16.84	20.28	20.40

Source: Central Bank of Egypt (2014).

<sup>1</sup> General Administration for Supply of Commodities, in charge of food subsidies

\*Budget only

The cost to the public budget underestimates the opportunity costs of subsidies. Fattouh and El-Katiri (2012: 38) argue that because of deadweight losses such opportunity costs – which encompass the social benefits from the alternative uses of scarce resources that are used towards subsidising consumer products – may amount to roughly twice the recorded financial costs of subsidies. And that estimate ignores the dynamic effects that subsidies have on the broader economy by encouraging overconsumption of certain sources of energy and food and deterring competitive entry. Artificially low prices also result in overconsumption, leakages, and black markets. Fattouh and El-Katiri (2012: 25) note that while energy intensity<sup>98</sup> has decreased in most industrialised countries around the world, it has been increasing in countries that use energy subsidies – including Egypt.

<sup>98</sup> Energy intensity is understood as a measure of energy efficiency of an economy, expressed in units of energy per unit of GDP.

The excessive incidence of subsidies on high-income groups is pronounced in the case of energy subsidies.<sup>99</sup> Abouleinein, El-Laithy and Kheir-El-Din (2009) show that in both urban and rural areas the top 20 percent of households (as measured by expenditures), receive by far the largest share of the total subsidy spending, and the share of the benefits received by other households decreases with their wealth, as proxied by household expenditures. This discrepancy is even stronger in urban areas, where it is likely driven by multiple car ownership among the wealthiest households. Unsurprisingly, the gasoline subsidy is the most regressive.<sup>100</sup>

Leakages, measured as differences between the observed supply and demand, are also significant. They represented 31 percent in the case of *baladi* bread in 2008/2009 (down from 40.8 percent in 2004/2005), and 20 percent in the case of sugar and cooking oil.<sup>101</sup>

Benefits from food subsidies, directed in part to inferior goods, accrue more evenly across different segments of the population - particularly after the reforms of the 1980s and 1990s, which eliminated subsidies to food items that were consumed mostly by the wealthy Egyptians.<sup>102</sup> Food subsidies, however, tend to have an urban bias, which is driven partly by the fact that households in rural areas are able to supply their own food.<sup>103</sup>

### **3.3.2 A history of failed reforms**

An early reform of food subsidies was introduced by president Anwar Sadat in 1977,<sup>104</sup> following almost a decade of growth in subsidy spending during which subsidies covered a variety of new foodstuffs, including corn, rice, or frozen fish and meat.<sup>105</sup>

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<sup>99</sup> This is in line with the finding by Del Granado et al. (2010) who find, on a sample of different developing countries, that the top quintile of the income distribution typically receives six times as much in energy subsidies as the bottom quintile.

<sup>100</sup> Vagliasindi (2012).

<sup>101</sup> World Bank (2010: 86). Egyptian Center for Economic Studies (2010) reports even significantly higher estimates.

<sup>102</sup> Ali and Adams (1996).

<sup>103</sup> Ahmed et al. (2001).

<sup>104</sup> Alissa (2007: 3).

<sup>105</sup> Ahmed et al. (2001: 6).

Though the series of protests that followed were dubbed ‘bread riots,’ the reform announced in January 1977 did not involve an increase in the price of coarse *baladi* bread nor a number of other staples such as lentils, beans, cooking oil and sugar. Subsidies were to be reduced on the more expensive *fino* bread, as well as the low-extraction flour from which it was made, rice, LPG, gasoline, cigarettes, and tea.<sup>106</sup> Riots that occurred led the government to cancel the reforms and instead expand the subsidy system.

In the late 1980s and early 1990s, some reforms were put in place – mostly as part of a structural adjustment programme administered by the IMF. In 1990, the prices of agricultural products – except for sugar – were liberalised. Petroleum prices, set at 36 percent of international prices in 1989 were raised to 100 percent in 1994. (ADB 1999: xi) The specific changes to food subsidies included targeting by introducing two categories of ration cards, a reduction of the number of subsidised foodstuffs, a reduction of people eligible to receive ration cards,<sup>107</sup> phasing out of certain commodities and their replacement with less heavily subsidised alternatives, a reduction of size of subsidised bread loaves.<sup>108</sup>

The real burden of food subsidy spending fell afterwards, but then started growing again.<sup>109</sup> In the 2000s, the government launched an extensive energy subsidy reform, increasing prices of gasoline and diesel oil and putting in place mechanisms for gradual electricity price increases, which took effect between 2005 and 2008. In 2008, natural gas prices were increased, and plans had been made for a complete elimination of energy subsidies by 2014. However, those efforts were abandoned in 2009 as the global economic crisis began to unfold, resulting in gradual increases in subsidy spending to unsustainable levels. In December 2012, the subsidy on 95-octane gasoline – used by

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<sup>106</sup> Ibid.: 7.

<sup>107</sup> Gutner (2002: 463).

<sup>108</sup> Ahmed et al. (2001: 9).

<sup>109</sup> Ibid.:8.



the wealthiest Egyptians – was scrapped. Instead of generating the savings that the government had hoped for, however, it induced consumers to shift to 92-octane gasoline,<sup>110</sup> creating shortages. In March 2013 an increase of the prices of LPG was announced, by 60 percent for consumers and by 100 percent for businesses.<sup>111</sup> Since 2012, the country has been suffering from a diesel shortage, 70 percent of which needs to be imported. Given the high subsidisation rate on diesel, the government is responding to the existing fiscal pressures by purchasing less fuel – a solution that can hardly be seen as lasting.<sup>112</sup>

While there has been no shortage of partial reforms, before and after the events of the Arab Spring, the successive Egyptian governments have failed to end subsidies to food and energy or to prevent increases in subsidy spending following cuts to such spending. To show how the framework outlined above in Section 3.2 accounts for the failure of Egyptian governments to sustain subsidy reforms, one needs to provide evidence for the lack – or weakness – of commitment devices available to prospective reformers in the country.

### **3.3.2.1 Gains sharing**

A subsidy reform accompanied by an explicit gains-sharing mechanism makes it difficult for politicians to capture the surplus of the reform since that would require a repeal of the gains-sharing mechanism in question – such as a cash transfer programme or tax cuts. The attempts to reform the subsidy system in Egypt did not include a sizeable increase of the existing social safety nets. In 1977, the announcement of price increases of subsidised food triggered riots because they were perceived as unfair. “Although the riots are commonly termed ‘food riots’, as noted above, they were in fact

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<sup>110</sup> Halime (2013).

<sup>111</sup> Daragahi (2013).

<sup>112</sup> Ibid.

‘equity riots’ since the underlying issues had more to do with the perception that the policy change was unfair, rather than the actual policy change itself” (Gutner 2002: 18).

Nor were later attempts to curb subsidy spending accompanied by a sizeable increase in cash transfers to the population. As late as 2005, only 0.12 percent of GDP was spent annually on cash transfers and the size of the Social Fund for Development (SFD), which had been established as part of previous reforms was around 0.18 percent of GDP. (World Bank 2005: iv)

### **3.3.2.2 Governance reforms**

Governance reforms involving the creation of independent regulatory bodies, rules-based pricing mechanisms or full liberalisation of markets in question remove the discretion over prices from politicians’ hands, making it more difficult for them to renege. Since its independence, Egypt was governed as an authoritarian system dominated by one political party. Under Nasser, the Arab Socialist Union (ASU) effectively controlled the government. After its demise in the mid-1970s, the National Democratic Party (NDP) – originally the centrist group in the ASU – became the only effective political organisation in the country controlling all levels of government and public administration. As such, the number of veto players in the political process was limited, placing few formal constraints on the range of policies that could have been adopted. A government that is not accountable to a majority of the population faces few constraints if it decides to renege on its promises, whether they pertain to the distributional or other aspects of a reform. Arguably, that account characterises the Egyptian situation well. Policies were introduced and repealed at the sole discretion of the ASU or NDP, with very little constitutional checks and balance. Repeated reversals of reforms further eroded the public’s trust of the government to tackle the problem. Furthermore, the attempts to reduce subsidies in the past have not been accompanied by consistent attempts to depoliticise price-setting in the area of food or fuels, or to

delegate those to an independent authority. A governance reform that would support the phasing out of subsidies could involve closing the relevant government agencies – the General Administration of the Supply of Commodities (GASC) or the parts of the Ministry of Petroleum in the case of Egypt. Such governance reforms have never been proposed.

In the area of energy, the elimination of subsidies would be aided by a privatisation and liberalisation of energy markets, making it more difficult for the government to re-impose price controls. So far there have been no signs of such liberalising reforms.

### **3.3.2.3 International agreements**

International agreements, such as loans from international aid agencies, can increase the costs of reneging on the reform or of the seizure of the surplus of the subsidy reform as long as these are conditional on the pursuit of the reform. In the Egyptian context, the most obvious instance of international agreements that could increase the costs of reform reversal were the country's dealings with the International Monetary Fund (IMF), which has repeatedly conditioned its assistance to the country on a pursuit of a reform of the system of subsidies.

In Egypt, the IMF conditionality played a limited role as a commitment device. A famous early reform of food subsidies was introduced by president Anwar Sadat in 1977 as part of negotiations with the IMF<sup>113</sup> following almost a decade of significant growth in subsidy spending. During this period, subsidies came to cover a variety of new foodstuffs including corn, rice, frozen fish and meat, and other items.<sup>114</sup> The reform, which aimed to reduce subsidies on fino bread, low-extraction wheat flour, rice, LPG, gasoline, cigarettes, and tea, was aborted following the riots that erupted in several Egyptian cities.

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<sup>113</sup> Alissa (2007: 3).

<sup>114</sup> Ahmed et al. (2001: 6).

In 1987, another loan agreement was reached, conditional on the pursuit of reforms including cuts to subsidy spending. Because of no progress in reforms, the IMF terminated it shortly after the initial disbursement in May 1987. In 1991, however, after Egypt had agreed on a broad reform programme for the economy, the IMF approved a \$372 million stand-by loan to support the reforms. This time around, significant reforms were introduced. In 1990, prices of agricultural products – except for sugar – were liberalised. Petroleum prices, set at 36 percent of international prices in 1989, were raised to 100 percent in 1994.<sup>115</sup> Subsidies were reduced and better targeted, and declined as a percentage of GDP from 3.8 percent in 1991/1992 to 1.6 percent in 1997/1998.<sup>116</sup>

As a result, the real burden of food subsidy spending fell, but started growing in the following years.<sup>117</sup> In other words, the effectiveness of IMF conditionality did not seem to extend beyond the duration of the structural adjustment programme. By the mid-2000s subsidy spending had reached high levels again. Furthermore, the structural programme agreed on with the IMF did not include an explicit commitment to a specific distribution of the surplus from the reform, and hence did not mitigate the problem of opportunistic seizure of surplus, which is central to credibility problems.

#### **3.3.2.4 Reputation**

Reputation is a commitment device that can be used by politicians who want to seek re-election. Reputation bestows on them an electoral advantage and makes their promises credible because of the ability of voters to punish politicians who do not live up to their reputation by not re-electing them. In the pre-2011 Egypt, such reputational mechanisms were absent because of the restrictions placed on electoral competition – namely, the country was under an effective one-party rule. Furthermore, the country

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<sup>115</sup> African Development Bank (1999: xi).

<sup>116</sup> African Development Bank (2000: 11).

<sup>117</sup> Ibid.: 8.

lacked functional mechanisms monitoring politicians' promises and deliverables – most importantly it lacked free media.

After the events of the Arab Spring, it would have been naïve to expect the quick emergence of reputational mechanisms. There is a sizeable literature describing commitment problems in emerging democracies.<sup>118</sup> Politicians in such settings have not yet created reliable channels of communication with their voters, which would allow them to make credible commitments on policy. Because they are either tied to the previous regime or are new to the political arena, they do not have a valuable reputation that could be used for the purpose of making commitments on policy.<sup>119</sup> The lack of political organisations and candidates who can make credible commitments about policy leads to political competition that revolves around patronage and distribution of special favours – and not around devising efficiency-improving reforms.

### **3.3.3 Alternative explanations**

While it does not seem necessary to leave the narrow area of public choice economics to explain the persistence of commodity subsidies, it is very plausible that the subsidies have become engrained in the Egyptian culture and *mētis* as the key element of the social contract between the government and the population. Testing such conjecture empirically would be extremely difficult and would go beyond the scope of the present thesis. In this section we provide examples of other alternative explanations for which such empirical test seems easier.

#### **3.3.3.1 Price volatility**

It is plausible to argue that cash transfers are an inefficient form of redistribution if food and energy represent a large fraction of household expenditures and if prices of those commodities are volatile. In that case, a transfer of cash, even if indexed by inflation,

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<sup>118</sup> See, e.g., Keefer and Vlaicu (2008).

<sup>119</sup> Roháč (2013c) points out that it is the religious groups who may potentially have the ability to make credible commitments over policy and public goods provision.

might not guarantee that poor households will be able to purchase some minimal amount of essential goods and services. If that were the reason behind the failure to adopt a system of cash transfers in Egypt, then it would be puzzling why the existing redistribution occurs dominantly through price controls and subsidies and not through rationing. If uncertainty over the availability of essential commodities were the main concern, then it would be difficult to explain why the government subsidises the prices of any amount of the commodity that gets sold through the official market, instead of using the existing system of ration cards or tradable vouchers to guarantee a quantity of goods available to each individual or household.

True, Egypt has imposed rationing on some commodities – including food and liquefied petroleum gas – but not on all. A systematic introduction of ration cards for fuels, for example, has yet to materialise. Hence if price volatility were the dominant concern, price subsidies would still be dominated by other policy tools such as vouchers or rationing.

#### **3.3.3.2 Lack of administrative capacity**

The use of subsidies can be related to the inability of the government to administer a system of transfers targeted at vulnerable groups within the population. This can be due to a lack of systematic, household-specific data on income, an inability of the government administration to perform proxy means-testing and so on. It is very likely that in the Egyptian context it would be problematic to set up a well-functioning system of social assistance, at least in the short run. In Jordan, which until recently appeared as a successful case of subsidy reform, the creation of a system of social assistance took years, since the creation of the National Aid Fund 1986, to changes that improved its

targeting in the 2000s.<sup>120</sup> In Egypt these difficulties are magnified by the sheer size of the population.

A lack of administrative capacity helps explain why subsidies arise as an alternative mode of redistribution, and why their transformation into a targeted system of social assistance does not occur. Although different methods for identification of poor households have long been entertained, including geographical targeting, electricity consumption or proxy means-testing<sup>121</sup> - they have never been deployed in the country on a larger scale. However, the existence of commodity subsidies represent a source of unexploited efficiency gains relative to a situation in which the government provided untargeted cash transfers to the population – a policy that would require only a very limited amount of administrative capacity. In other words, if the lack of administrative capacity were the binding constraint on reform, setting up an untargeted cash transfer scheme would still be an improvement over the existing system.

Furthermore, the example of Jordan suggests that the lack of administrative capacity is not on its own a binding constraint. Over several years, the Jordanian government invested in the expansion of the National Aid Fund, which largely replaced subsidies as an instrument of social assistance. The reintroduction of subsidies in 2010 was driven by the fears of political instability in the aftermath of the Arab Spring – not by administrative dysfunctions of the cash transfer programme.

#### **3.3.3.3 Alternative public choice mechanisms**

The existence of the subsidy system could be due to the presence of strong and organised special interests that have hijacked the political process for their own benefit. Although small groups within the Egyptian society derive a disproportionate share of benefits of the subsidy spending, an account relying on the presence of special interests

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<sup>120</sup> Coady et al. (2006: 19-21).

<sup>121</sup> World Bank (2005: 15). See also Ahmed and Bouis (2002).

needs to explain why the opposition to subsidy reforms has been driven by popular unrest. The existence of vested interests is not sufficient to explain the persistence of inefficient policies like Egypt's subsidy system. A causal mechanism needs to be outlined, which prevents political bargains from occurring.

Similarly, the idea of a 'transitional gains trap',<sup>122</sup> advanced by public choice scholars as an obstacle to reform, appears incomplete as an explanation for the persistence of inefficient policies.<sup>123</sup> According to Tullock's original interpretation, transitional gains are a barrier to reform because there is no feasible way of compensating the losers of the reform. But that is a testable claim, and its validity depends on the institutional environment and character of the policy reform in question. In the case of Egypt, contrary to Coate and Morris (1999), strong incentives seem to exist to deviate from the existing status quo – after all, the fiscal savings from removing wasteful subsidies would be considerable, not to mention the dynamic effects on the supply of commodities that are currently subsidised.

The distribution of surplus is often seen as a pressure point in reaching efficiency-enhancing bargains. Given that the incidence of benefits from the existing subsidy reform is well-documented, it seems unlikely that uncertainty over the distributional effects of the reform<sup>124</sup> would be a major factor hampering reform. Similarly, an ex-ante disagreement over the distribution of the surplus from the reform<sup>125</sup> does not seem to be a decisive factor. With the possible exception of the wealthiest households,<sup>126</sup> which receive the bulk of the energy subsidy spending, most Egyptian households would benefit from a switch to universal, non-distortionary, cash transfers.

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<sup>122</sup> Tullock (1975), Tollison and Wagner (1991).

<sup>123</sup> See, e.g., Thomas (2009) for a case study of an efficiency-enhancing reform that occurred despite transitional gains.

<sup>124</sup> Fernandez and Rodrik (1991).

<sup>125</sup> Alesina and Drazen (1991).

<sup>126</sup> Abouleinein, El-Laithy, and Kheir-El-Din (2009).



In short, the account presented in this chapter is consistent with the standard public choice literature in the sense that it identifies a specific failure of the political process to deliver efficient outcomes. As in Acemoglu (2003), the mechanism that enables inefficient subsidies to persist relies on the inability of the government to bind its future actions. While other factors might have contributed to the failure of Egyptian politics to generate a sustained policy reform, this section has shown that the usual commitment devices have been weak or absent in the Egyptian context, making the story of repeated reform failure consistent with a model that relies on the lack of policy credibility as the main factor driving policy failure.

### **3.4 Conclusion**

The puzzling existence and persistence of policies that entail large social losses can be explained by the inability of prospective reformers to commit to a credible reform path.

Although the problem of policy credibility can be addressed by appropriate policy design, the severity of the subsidy problem in a country like Egypt is related to the institutional context in which the political process operates. The corollary is that policy problems, such as subsidies, may become easier to solve as Egypt, alongside with other Arab Spring countries, moves towards better functioning modes of governance. The chances of a sustained reform would be improved in a competitive political environment with politicians who are able to make credible pre-electoral promises. Similarly, delegating part of the power to veto a reform reversal to players outside of the political process – e.g. to independent regulators – would also increase the costs of reform reversal, provided that the governance structure is perceived as credible.

Taking the institutional deficiencies that lead to credibility problems – such as a lack of reliable channels of communication between politicians and voters – as given, appropriate design of reforms can help overcome the problem.

Specifically, a credible reform will need to be (1) complete, quick, and simple to implement, (2) accompanied by a compensation scheme directed at those segments of the population who are deriving net benefits from existing subsidies, and (3) accompanied by reforms that would improve the functioning of markets in commodities that are being subsidised. In some respects, these recommendations are consistent with the conclusions of different studies that have synthesised the lessons from subsidy reforms around the world.<sup>127</sup> However, putting credibility at the forefront of the discussion leads to a departure from an approach that sees subsidies as a technical problem that can be addressed by political fiat, particularly by stressing the need for a quick and complete reform. The concluding part of this thesis, Chapter 6, will discuss the practical implications of such an approach.

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<sup>127</sup> See, e.g. Vagliasindi (2012), World Bank (2005), Coady et al. (2010), Commander (2012). The IMF (2013) has recently revisited reforms in 22 different countries and summarised the key elements of a successful reform as follows:

“(i) [A] comprehensive energy sector reform plan entailing clear long-term objectives, analysis of the impact of reforms, and consultation with stakeholders; (ii) an extensive communications strategy, supported by improvements in transparency, such as the dissemination of information on the magnitude of subsidies and the recording of subsidies in the budget; (iii) appropriately phased price increases, which can be sequenced differently across energy products; (iv) improving the efficiency of state owned enterprises to reduce producer subsidies; (v) targeted measures to protect the poor; and (vi) institutional reforms that depoliticise energy pricing, such as the introduction of automatic pricing mechanisms.”

Furthermore, Roháč (2013e) provides a discussion of prospects of a subsidy reform in Egypt, drawing on the experience of successful energy subsidy reforms in Turkey, Philippines, Brazil, Chile, Kenya and Uganda. These reforms tended to be implemented by governments with strong popular mandates. In all of these examples above, some mitigation or compensation schemes were used to balance the impact of the reforms on the population. Growing fiscal imbalances seemed as a powerful impetus for reform. Finally, in all of the cases, subsidy reforms were a part of a larger reform packages that aimed to improve the functioning of energy markets. In contrast, Nigeria’s failed subsidy reform is an extreme example of how such reforms can be derailed if the population has a low level of trust in the government, which it perceives as essentially self-interested, if not predatory (Commander 2012: 25-26).

## 4 Religion as a Commitment Device: The Economics of Political Islam<sup>128</sup>

### 4.1 Introduction

Throughout the Middle East and North Africa (MENA), Islamic political parties, many of them part of the Muslim Brotherhood, have gained influence over the recent years. Until the military takeover in Egypt in July 2013, the most populous Arab country had been governed by the Freedom and Justice Party, a political organization of the Brotherhood. In other countries as well, Islamic organisations count among the most important political forces in the region. But why have they become so popular among the voting public?

Unlike common accounts for the political patterns in the Middle East, which revolve around the religious identities of the Arab peoples,<sup>129</sup> the repressive nature of the previous regimes,<sup>130</sup> poverty and underdevelopment,<sup>131</sup> or Arab nationalism and grievances against Israel,<sup>132</sup> our paper offers a rational choice-based explanation for the popularity of Islamic parties in the Arab Spring countries. We explain religious politics as a solution to the problem of credible pre-electoral commitment that plagues new and emerging democracies. Voters will prefer political groups that can make credible promises to supply public goods after the elections, but such political groups are rare. Politicians in new and emerging democracies seldom have the opportunity to invest in the technology of making credible commitments, which includes establishing reliable channels of communication with voters and methods of tracking their promises and their deliverables.<sup>133</sup> Voters then tend to support politicians who make credible

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<sup>128</sup> A version of this chapter was published in *Kyklos* as Roháč (2013c).

<sup>129</sup> Gilsonan (2000).

<sup>130</sup> Garcia-Rivero and Kotze (2007).

<sup>131</sup> Evans and Phillips (2007).

<sup>132</sup> Stepan and Robertson (2003).

<sup>133</sup> Jottier et al. (2012) show that the problem of communication between voters and politicians goes in both directions and that complexity affects politicians' knowledge of voters' preferences.

promises about transfers, through a system of patronage. Patronage works because although politicians are not credible to voters, they can make credible promises about transfers to intermediaries, patrons, who are, in turn, able to make credible commitments to their clients. The political process encourages transfers directed at the groups that are relevant for re-election and provision of too few public goods.

Islamic parties have characteristics that enable them to make commitments that are credible to voters. Firstly, they are well-known for being involved in the provision of collective goods for their members and wider communities for a long time, which adds to their credibility in making promises about the supply of public goods in the future. Islamic parties are far from being a homogenous group across the countries of the Middle East and North Africa. Some of them – namely the parties in Egypt, Libya, Algeria, Lebanon, Palestine, and Syria – belong to the Muslim Brotherhood, a network that has operated in Arab countries for decades, often in spite of official repression. Other groups, such as the Islamic parties in Morocco and Tunisia, are not part of that network, although they do share some structural similarities. While secular dictatorships in Arab countries repressed political opposition, they usually allowed the existence of organisations that provided community services, health care, education and so forth. The exceptions were Libya and Syria, where near-totalitarian nature of the regimes did not allow for the operation of religious organisations in the area of provision of social services and local public goods. However, where allowed to operate within that space, the religious organisations have become singularly successful, and their religious nature enhanced both their ability to overcome collective action problems and to make believable promises.

We show that a rational choice-based explanation is consistent with reality at various margins: we note that religious groups command broad popular support in Arab Spring countries, especially in countries where they have had a long-standing presence, we find

that support for Islamic political groups is not related to a specific set of policy preferences, and finally we document that the religious political organisations were previously involved in supplying social services or club goods. This supports the notion that religious organisations might possess an advantage at providing such goods,<sup>134</sup> and also that reputation created by providing such goods can be transferred into the political arena and can serve as a basis for making credible pre-electoral commitments.

Our argument does not rely on specific substantive claims about Islam or any other particular religion, but rather on an understanding of religion as a node of social organisation. The success of Islamic parties in the Arab Spring countries is not predicated on their idiosyncratic Islamic characteristics, but rather on the fact that their precursors were allowed by former regimes to operate in the sphere of provision of social services and club goods. In contrast, in post-communist Eastern Europe, the fall of communism did not lead to a rise of political Catholicism as a major political force in countries that had traditionally been Catholic. According to our stylised verbal model, this can be explained by the fact that, unlike in Arab countries, Communist regimes persecuted churches, and did not allow them to operate large community and social-service schemes. As a result, Catholic or broadly Christian political parties did not seem to enjoy any distinct electoral advantage. That being said, it is obvious that religion influences social, economic, and political outcomes in more ways than just one. Islam, therefore, is a part of the *mētis* in many countries of the region under consideration, and we do not pretend that its discussion in this chapter is exhaustive by any means.

While political Islam has been studied by numerous scholars, no existing contribution applies both the public choice analysis of credibility problems and the insights from the economics of religion to the issue of political Islam. True, some scholars work in the

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<sup>134</sup> The question of whether religious beliefs promotes trust and facilitates cooperation in public goods games has not been settled. For two conflicting pieces of evidence, see, e.g. Sosis (2005), Anderson and Mellor (2009) and Anderson et al. (2010).

general area – e.g. Kalyvas (2000) who analyses the problem of commitment of religious parties to a system of secular democracy, Berman (2003) who sees the rise of political Islamism as a consequence of the political failure of Arab governments, or Carvalho (2009) who studies the Islamic revival since the 1970s by analysing the role of unfulfilled aspirations and income inequality. Following seminal contributions by Kuran (2001, 2004), some have explored the link between Islam and underdevelopment.<sup>135</sup> Others have focused on explaining the electoral advantage of Islamic parties – which is indeed the route taken by this chapter as well. For example, evidence from Indonesia suggests that the main advantage of Islamic parties stems from the uncertainty surrounding the true platform of other parties on matters of economic policy,<sup>136</sup> whereas other studies stress the importance of their anti-corruption platforms.<sup>137</sup> It has been also shown that the Muslim Brotherhood in Egypt, unlike the official, government-approved political groups, lacked the funds needed to engage in politics of patronage by bribing poor people directly (Massoud 2010). Islamic groups have also been successful in providing goods, such as education, to groups that would have otherwise been marginalised, such as religious conservatives (Meyersson 2013).

## **4.2 Religious politics and policy credibility**

Islamic parties can be seen as a solution to the problem of credibility in new and emerging democracies as described by Keefer and Vlaicu (2008). In their model, politicians in new and emerging democracies are not able to make credible pre-electoral commitments to the supply of public goods. This is because credibility requires costly investments from the part of the politicians. Credible promises require the presence of reliable channels of communication, so that candidates can communicate their promises

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<sup>135</sup> See Platteau (2008) and Richards (2005). Relatedly, see also Grier (1997) for a study of the effect of Catholicism on economic development, Lewer and Van den Berg (2007) and Helble (2007) for an analysis of the effect of religion on trade.

<sup>136</sup> Pepinsky et al. (2012).

<sup>137</sup> Henderson and Kuncoro (2006).

to voters. They also require that voters can observe the actions of politicians and compare them against the promises. Alternatively, credibility requires repeated interaction, and existence of reputation. These features may not be present in a new democracy.

Typically, non-credible politicians face two options. Firstly, they can invest in building a reputation by informing voters about their promises, tracking those promises and letting the voters assess the deliverables. That process is costly and takes time to work. Alternatively, they can use intermediaries – patrons – who are already able to make credible promises about transfers to their clients. Patrons can make credible promises because of their role in society and because of their past reputation. If the candidate can make credible promises about transfers to a small number of patrons, then the problem of credible pre-electoral commitment can be mitigated even though politicians themselves are unable to make credible promises to voters. Promises made through patrons pertain to targeted transfers, not to the provision of public goods. This is because patrons can extract surplus from transfers, but not from public goods.

The key implication of Keefer and Vlaicu (2008) is that new democracies, which rely on patronage, will suffer from an underprovision of public goods and from an overprovision of transfers to specific constituencies. The effect on governance dissipates over time as politicians build a reputation that enables them to make credible commitments to the provision of public goods. It is worth noting that the clientelism, which is pervasive throughout new and emerging democracies, is in fact welfare-enhancing relative to a situation in which politicians would not be able to make any binding commitments. However, it is a source of distortions relative to the first-best scenario under which politicians would be able to make credible pre-electoral promises about public goods provision. Yet, over the long run, as Keefer and Vlaicu argue, patronage can create disincentives for politicians' investment in their ability to make

credible promises to the electorate, resulting in prolonged periods of bad governance and redistributive politics.

Religious parties in general and Islamic parties in the Middle East in particular, are able to eschew patronage and make credible promises about public goods. Most importantly, churches, sects and other religious organisations have mechanisms that enable them to provide commodities that display public goods characteristics, by screening their members for free riding through injunctions on certain kinds of behaviour, or through sacrifice and stigma.<sup>138</sup>

How does joint production occur in a religious organisation? Firstly, it is worth noting that this production occurs during non-market time. Regardless of whether the religious organisation maximises the utility of its members – as when religious markets are competitive – or whether it maximises the amount of consumption of religious goods – as when switching between religions is costly – members who are engaged in market production impose a negative externality on other members of the religious group. Efficient religious groups would ideally like to discourage involvement in market production by taxing market wages. Without the power to tax earned market income directly, religious prohibitions are a way of taxing consumption. These methods of “taxation” include sacrifices and stigma, which both reduce the returns to market activities, and also restrictions on dress or diet, which can either be costly in their own right, or make interaction with non-members of more difficult. These help members signal commitment to the group and create a barrier against potential lukewarm members, who would free ride on goods produced by the religious organisation.

Creating and sustaining horizontal networks that are successful at providing club goods or local public goods requires overcoming collective action problems. Our argument,

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<sup>138</sup> See Iannaccone (1992) and Iannaccone and Berman (2006). See also Smith et al. (1998) for a model of religious participation, accompanied by cross-country evidence.



relying on specific features of religious organisations, can be seen as an extension of the work by Ostrom (1990) who showed that groups are able to overcome collective action problems if their behaviour is governed by certain principles, e.g., having clearly defined boundaries, autonomy from external enforcement, presence of a system for monitoring members' behaviour, undertaken by community members, a graduated system of sanctions, low-cost resolution mechanisms and so on. As we show in Section 3.3.1, such mechanisms exist within religious organisations and specifically in groups like Muslim Brotherhood.

Finally, if religious beliefs of Islamic politicians are common knowledge, then their promises can be made credible by the existence of post-mortal rewards and punishments. How can one determine whether leaders of religious parties are sincere in their religious convictions? As before, stigma and sacrifice provide a screening mechanism that makes it possible to sort the genuine believers from free riders. Hence, some religious parties adhere to more extreme interpretations of the Koran, as it pertains to dietary habits or dressing, as a way of signalling credibility. As a result, signalling religious beliefs makes political promises more believable, even for people who are not religious.

#### **4.2.1 Implications**

One way of assessing whether this stylised model matches reality in the aspects that we care about is to compare its predictions against the reality observed in the Arab world.

##### **4.2.1.1 Individual religiosity is a poor predictor of voting behaviour and policy preferences**

In the model outlined above, individuals do not vote for religious parties because they are themselves religious, or because they have a preference for any specific religious policy agenda. They vote for religious parties because a platform that can credibly promise public goods is preferable to a platform that engages only in transfers and

redistributive politics. In this setting, voting for a religious party does not imply any preferences over specific public goods that ought to be provided – only a preference for some nonnegative supply of them in individual optimum. Religious parties can be expected to attract voters if they can credibly promise them a bundle of public goods and transfers.

#### **4.2.1.2 Successful religious political groups will have a reputation – e.g. a track record of successful provision of social services**

A track record of provision of services to their communities can be used for making credible electoral promises about the supply of public goods at large. This holds regardless of whether the initial provision is intended as a means aiming at gaining an electoral advantage or whether it is motivated by other ends. Religion provides a natural node for the community provision of social services, health, education and other commodities that may display the characteristics of public goods. Through sacrifice, stigma and costly mechanisms of signalling commitment, religious organisations are particularly well-suited to overcome free rider problems and, as a result, to provide club goods to their members or local public goods to wider communities.

#### **4.2.1.3 Religious parties with established mechanisms of making credible commitments will possess a distinct electoral advantage**

Political organisations that can make credible pre- electoral commitments about the supply of public goods can be expected to do well among the electorate. From the perspective of the median voter, a credible politician can do everything that a politician relying on patronage can do, *plus* he can also provide a positive amount of public goods. In other words, non-credible candidates face the same maximisation problem as the credible ones, but are subjected to the additional constraint of being unable to provide public goods in equilibrium. From the perspective of the pivotal voter, credible candidates always dominate non-credible ones.

### 4.3 Islamic politics in the Middle East

This section will first provide a short background description of the Islamic political landscape in Arab countries, and then discuss the extent to which the prediction made by our stylised model match the observed reality.

#### 4.3.1 Muslim Brotherhood: Background

Many Islamic parties in Arab countries are part of an organised network running across countries – the Muslim Brotherhood. The Brotherhood was founded in Egypt by Hassan al-Banna in 1928 to promote the ideas of a "total self-sufficiency" of Islam.<sup>139</sup> Also known as the *Jamiyyat al-Ikhwan al-Muslimin*, it intended to fight the colonial regime through religious exaltation.<sup>140</sup> Banna considered the Islamic Caliphate as the ideal form of government for Arab peoples, and as a means of responding to the failure of liberal institutions in the wake of Egyptian independence from the British in 1923.<sup>141</sup>

The Brotherhood quickly started to play a major role in Egyptian politics. Under Nasser, the tensions between the government and the Brotherhood mounted but the Brotherhood remained popular. Started in 1962, Nasser's initiative to undertake the modernisation of Yemen and other Arab states fell flat over time, and, instead, exacerbated Egypt's decade-long economic crisis, culminating in its defeat in the Arab-Israeli War in 1967. According to the Brotherhood, Egypt's failure, both economic and political, was a direct result of its failure to internalise the teaching of the Koran and *sharia*.<sup>142</sup>

Before the military takeover in July 2013, the Egyptian Muslim Brotherhood had close to 300,000 members<sup>143</sup> and was based on the principle of *da'wa*, which calls for every Muslim to participate in building the Islamic society.<sup>144</sup> In this spirit, the Brotherhood

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<sup>139</sup> See Said Aly and Wenner (1982) or Paison (2009).

<sup>140</sup> Leiken and Brook (2007: 108).

<sup>141</sup> . Also see Mitchell (1993) for a classic work on the history of the Brotherhood. For accounts of more recent developments, see Wickham (2011) and Tadros (2012).

<sup>142</sup> Aly and Wenner (1982: 345).

<sup>143</sup> Council on Foreign Relations (2012).

<sup>144</sup> Paison (2009: 9).

in Egypt runs hospitals, schools, banks, businesses, charities and social clubs. The Brotherhood has also become a major provider of aid amongst Muslims.<sup>145</sup> In 1935, the Syrian branch was opened, operating in exile, followed by a branch in Jordan in 1942, which later became Jordan's Islamic Action Front. In 1954, Algeria's Movement of Society for Peace had gained prominence, followed by the *Jamaa Islamiyya* in Lebanon in 1964. Their example also inspired Tunisia's *Ennahda* Movement in 1981, Palestine's *Hamas* in 1987, Yemen's *Islah* in 1990, and Kuwait's *Hadas* in 1991. More recently, the Brotherhood started official political parties in Bahrain (*Al Menbar*, 2001), Egypt (Freedom and Justice Party, 2011) and Libya (Justice and Construction Party, 2012).<sup>146</sup>

#### **4.3.2 Islamic political groups and policy credibility**

To assess whether our stylised verbal model can provide a useful perspective on the rise of Islamic politics in the Arab Spring countries, we compare its key empirical predictions with outcomes observed in reality:

##### **4.3.2.1 Individual religiosity is a poor predictor of voting behaviour and policy preferences**

Our argument predicts that individual voting behaviour and support of religious parties should be independent of individual ideology. That is, people vote for Islamists not because of a preference for 'religious' content in politics and policy making, but because they expect them to deliver public goods. Our thesis could be invalidated by two classes of results: (a) if religiosity were a strong predictor of actual voting for religious parties, or (b) if support for religious politics were associated with a well-defined set of policy preferences in the Downsian space.

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<sup>145</sup> Ibid.: 19.

<sup>146</sup> To illustrate how widely the Brotherhood network is spread, Table 8 in the appendix summarises the main Islamic political groups in selected countries of the MENA region. In all of the countries under consideration, with the exception of Tunisia, the Muslim Brotherhood is represented. And although Tunisia's *Ennahda* Movement is not part of Brotherhood's network, it is modeled after its example and its representatives often cite the Brotherhood as a model for their organisation.

In Muslim majority countries, the documented links between personal religiosity and political and voting behaviour are not very reliable. This is at odds with the evidence from Europe where Catholicism is a strong predictor of voting for Christian Democratic parties.<sup>147</sup> To be sure, the connections between religiosity and voting behaviour are underexplored in the context of Muslim-majority countries because of data limitations.

With the exception of Turkey,<sup>148</sup> religious cleavages do not seem to affect voting behaviour in Muslim majority countries. Tessler (2002) studies individual-level data from the Palestinian territories, Morocco, Algeria, and Egypt and shows that Islam has only a small impact on political attitudes, especially on attitudes towards democracy, and very little explanatory power in accounting for support for democracy in Arab countries. Muslims – just like their non-Islamic counterparts – do favor democracy and political liberalisation.<sup>149</sup> In Lebanon, religiosity is not a significant predictor of political activism.<sup>150</sup> Likewise, in the world's most populous Muslim-majority country, Indonesia, religiosity was not significant in explaining voting behaviour in the elections of 1999 and 2004,<sup>151</sup> and neither does an 'Islamic ideology' explain the support for Indonesia's religious parties.<sup>152</sup> In Central Asia, religious affiliation does not affect preferences for democracy and political Islam.<sup>153</sup> In the same vein, Rose (2002) finds that “there is little difference between Muslims, the Orthodox, and non-believers in Central Asia. Even more strikingly, the most observant Muslims are almost as pro-democratic as those who are non-observant.”<sup>154</sup> He concludes that “neither nominal

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<sup>147</sup> Botterman and Hooghe (2012), Van der Brug et al. (2009).

<sup>148</sup> Carkoglu (2005), Baslevant et al. (2005).

<sup>149</sup> Inglehart and Norris (2003).

<sup>150</sup> Cammett (2010).

<sup>151</sup> Liddle and Mujani (2007).

<sup>152</sup> Pepinsky et al. (2012).

<sup>153</sup> Collins and Owen (2012).

<sup>154</sup> Rose (2002: 110).

religion nor the degree of religious observance has much influence on democratic values.”<sup>155</sup>

Is political Islam is connected with any consistent pattern of policy preferences in the Downsian policy space, or an ‘Islamic ideology’? To investigate this question, I run a series of logit/ordered logit regressions in which I relate a composite variable reflecting individual preference for the presence of Islam in politics (*Political Islam*) to a number of variables capturing individual preferences over the key attributes of democracy, relative salience of different policy areas, or performance of the government. While not encompassing all important policy areas, the survey data provide one with at least an impressionistic information about individual policy preferences. Table 3 below summarises the findings of our regressions, in which individual socioeconomic status was controlled for, as well as country characteristics.<sup>156</sup>

Table 3 reveals a lack of statistical significance of *Political Islam* in most specifications. The only issues that can be linked to *Political Islam* are the beliefs that elections are the most important component of a democracy (*Elections*), the idea that human rights violations are justified by stability and security needs of a country (*Human rights violations OK*), and the belief that corruption is the most pressing problem of the respondent’s country (*Corruption*).

Table 3 Political religiosity and policy preferences. Logit/ordered logit regressions, with country fixed effects

Dependent variable			Coefficient on <i>Political Islam</i>	Robust standard error	4.4 N
What would you choose as the most important characteristic of democracy	<i>Elections</i>		0.137***	(0.047)	3162
	<i>Freedom to criticise</i>		-0.04	(0.051)	3162
	<i>Small income gap</i>		-0.04	(0.052)	3162
	<i>Necessities for everyone</i>		-0.059	(0.049)	3162

<sup>155</sup> Ibid.: 110.

<sup>156</sup> For full results, refer to Tables 12, 13 and 14 in the appendix.

How well or badly is the government managing the following matters? (1-very well, 2-well, 3-badly, 4-very badly)	<i>Managing Economy</i>	0.006	(0.036)	4372
	<i>Creating Jobs</i>	-0.03	(0.036)	4427
	<i>Narrowing Gap</i>	-0.009	(0.036)	4317
	<i>Improving Health</i>	-0.055	(0.035)	4463
	<i>Improving Education</i>	-0.008	(0.036)	4469
	<i>Improving Morality</i>	-0.003	(0.037)	4080
To what degree would you agree that the violation of human rights in [country] is justifiable in the name of promoting security and stability?	<i>Human rights violations not OK</i>	0.073**	(0.035)	4414
In your opinion which of the following is the most important problem facing [respondent's country] today?	<i>Economy</i>	-0.039	(0.041)	3561
	<i>Corruption</i>	0.143***	(0.045)	3561
	<i>Authoritarianism</i>	-0.107	(0.097)	3561
	<i>U.S. occupation of Iraq</i>	-0.233	(0.162)	3126
	<i>Arab-Israeli conflict</i>	-0.152	(0.109)	3561

\* p<0.1, \*\* p<0.05, \*\*\* p<0.01. Description of variables used can be found in Tables 8 and 9 in the Appendix. Full results are reported in Tables 12, 13, and 14 in the Appendix.

Because of the coding of individual questions, it is important to carefully think through the exact signs of the observed effects. The coding for the *Elections* variable is simple: 1 in case the respondent considers it the most important feature of democracy and 0 in case (s)he does not. As a result, those who attach greater value to the presence of Islam in politics will be more likely than others to think that elections are the most important feature of democracy. The coding for the variable *Human rights violations not OK* is the following: 1 - Completely justified, 2 - Somewhat justified, 3 - Not very justified, 4 - Not justified at all. Hence, higher values of *Human rights violations not OK* indicate a lower degree of comfort with human rights violations. The negative sign on *Political Islam* is then an indication that those who attach greater value to the presence of Islam in politics will be more likely than others to oppose human rights violations done in the name of preserving stability and security of a country. Finally, the coding of *Corruption* is simple: 1 in case the respondent considers it the most pressing issue, 0 otherwise. Thus those who attach greater value to the presence of Islam in politics will be more

likely than others to think that corruption is the main problem plaguing their respective countries.

Perhaps more interesting than these findings are the remaining *non-findings* presented in Table 3. Apart from *Elections*, *Political Islam* has no predictive power over the remaining attributes of democracy, no predictive power over whether the government is doing a good or a bad job in a variety of areas, and does not predict whether the respondents are likely to pick out of the listed issues, with the exception of corruption.

Although we have not provided a direct test of whether *Political Islam* is related to any specific set of policy preferences in the Downsian space, results presented in Table 3 are difficult to square with an understanding of political Islam as a reflection of a specific ideological view about policy, informed by religion. If being an ‘Islamist’ affected where one stood in the Downsian space, one would expect that *Political Islam* would exercise strong effects across a variety of policy-related beliefs. Our results indicate that it does not.

#### **4.4.1.1 Successful religious political groups will have a reputation – e.g. a track record of successful provision of social services**

The Muslim Brotherhood, as well as other Islamic groups in the MENA region, has been involved in the provision of social services, including health services, education, welfare assistance and humanitarian aid. Although authoritarian regimes in Arab countries suppressed political opposition, they tolerated the existence of organisations providing social services. The important exceptions include Libya and Syria, where the operations of the Brotherhood were suppressed by the country regimes. In Syria, Brotherhood membership was a capital offence between 1980 and 2011, and similarly in Libya the regime banned any social work by Islamists.



It is worth stressing that these activities of the Islamists were different from standard patronage schemes.<sup>157</sup> Unlike patronage, which involves vertical relations between a patron and multiple clients, religious organisations have created horizontal networks that are not based on personal allegiances but rather on joint production by group members.<sup>158</sup> This is because they are able to overcome the free rider's problems through the mechanisms of stigma and sacrifice, as explained in section 4.2.

In Algeria, Islamic groups were among the first and most effective organisations to help the victims of the Algiers earthquake in 1989.<sup>159</sup> The precursor of the Movement of Society for Peace (MSP) itself was started by Mahfouh Nahnah as an organisation for preaching, religious education and charity. When it was transformed into a political party in 1990, it encompassed four major centres, around 40 *wilaya* (province) sections and 916 offices in municipalities, 133 of which were women's offices. Its political activities ran alongside social assistance for finding employment, helping families, widows and the needy, as well as access to medical care. The MSP plays a socialising role for activists and supporters, giving them a network of solidarity within which members can find spouses, get help setting up businesses via investment vehicles (known as 'tontines'), or find accommodation.<sup>160</sup>

In Morocco, the Justice and Development Party (PJD) itself is not active in the provision of social services, but its umbrella organisation, the Unity and Reform Movement (MUR), is most notably active at the local level.<sup>161</sup> Usually, local counselors

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<sup>157</sup> Clark (2004b).

<sup>158</sup> Interestingly, in Egypt, it was traditionally the governing NDP party that was involved in patronage in the traditional sense – offering bribes for votes, or coercing poor and often illiterate voters into voting for its candidates (Blaydes 2006: 5).

<sup>159</sup> Esposito (1999: 176).

<sup>160</sup> Boubekour and Amkar (2006: 12).

<sup>161</sup> Morocco features an influential Islamic group Justice and Charity, founded by Sheikh Yassine, providing food, health care, and literacy classes to the urban poor (Howe 2005: 130). It is also involved in Islamic teaching - while steering away from participating in formal politics. As one former leftist political prisoner put it in an interview, 'political parties of the left have abandoned this strategy of providing social services directly. Their strategy is to make changes from the top, by being involved in the political process. NGOs that have leftist leanings do that work now.' Another difficulty that they encounter is, as

for the MUR are also active in various associations providing services to the citizens, and increasing their credibility as local politicians.<sup>162</sup>

In Tunisia, *Ennahda's* precursor, the *Movement of the Islamic Tendency*, has developed a network of social service provision and built a presence at the local level of government. Furthermore, it has traditionally operated numerous civic associations (Troudi 2011: 172) including sporting clubs, and organised collective weddings, free of charge.

Likewise in Egypt, the involvement of Muslim Brothers in the provision of social services has been well documented.<sup>163</sup> “Countrywide, the Muslim Brotherhood runs 22 hospitals and has schools in every governorate in the country. The organisation also runs numerous care centres for poor widows and orphans as well as training programmes for the unemployed. [...] Of the roughly 5,000 legally registered NGOs and associations in Egypt, an estimated 20 percent are brotherhood-run.”<sup>164</sup>

Jordan and Yemen are no exceptions.<sup>165</sup> In Jordan, the Brotherhood operates, inter alia, the Islamic Hospital in Amman<sup>166</sup> and the al-Afaf Charitable Society, providing collective weddings and matchmaking services.<sup>167</sup> In Yemen, the *Islah* party has created welfare, religious and educational organisations that deliver social services. Most notably, the Islah Social Welfare Society engages in health awareness campaigns, religious education, illiteracy eradication, and relief donations.<sup>168</sup>

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one militant lamented, 'the lack of financial means,' while Islamists have considerable funds at their disposal (Cavatorta 2006: 217).

<sup>162</sup> Catusse and Zaki (2009).

<sup>163</sup> See, e.g., Davis and Robinson (2012) or Clark (2004a).

<sup>164</sup> See IRIN (2006) and also Harrigan and El-Said (2009) and Clark (2004b).

<sup>165</sup> On Jordan, see Wiktorowicz (2001).

<sup>166</sup> Wiktorowicz (2002: 234).

<sup>167</sup> Wiktorowicz and Farouki (2000).

<sup>168</sup> Hamzawy (2009: 6), Brown and Hamzawy (2010: 140).

As far as Lebanon's Hezbollah is concerned, the "Social Unit" is one of the eight key elements of Hezbollah's structure.<sup>169</sup> It provides social welfare services as well as technical help and has set up institutions from agricultural cooperatives to cultural centres.<sup>170</sup> The same goes for Hamas in the Palestinian territories, where its opportunities are compounded by the failure of the Palestinian authority to provide basic welfare infrastructure. Hamas thus runs relief programmes, funding schools, orphanages, mosques, healthcare clinics, soup kitchens, and sports leagues.<sup>171</sup>

#### **4.4.1.2 Religious parties with established mechanisms of making credible commitments will possess a distinct electoral advantage**

Parties organised within the Muslim Brotherhood command large popular support. Table 4 presents the results of recent elections held in Arab Spring countries. With the exception of Algeria, Jordan and Libya, Islamic parties or Islamic coalitions – typically led by a Brotherhood party – came in first.

Table 4 Performance of Islamic parties in recent legislative elections in countries of the Middle East and North Africa

Country	Party/Coalition	Elections held	% of votes
Egypt	Democratic Alliance for Egypt*	November 2011 – January 2012	37.5
	Islamist Bloc		27.8
Tunisia	Ennahda Movement	October 2011a	37.04
Morocco	Justice and Development Party*	November 2011	22.8
Libya	Justice and Construction Party*	July 2012b	10.27
Algeria	Green Algeria Alliance*	May 2012	6.22
Jordan	Islamic Action Front*	November 2010	N/A

\*Party is part of the Muslim Brotherhood, or the coalition is led by a party that is part of the Muslim Brotherhood

<sup>a</sup> Election into Tunisia's constituent assembly

<sup>b</sup> Election into Libya's General National Congress.

<sup>169</sup> Hamzeh (2004: 49).

<sup>170</sup> Hamzeh (2004), Jawad (2008).

<sup>171</sup> Milton-Edwards (2007: 305), Levitt (2006: 16).

The results are mixed, with Islamic parties making significant gains in some countries, while performing relatively poorly in others. It therefore is worth disaggregating them and inspecting them on a by-country basis. In the Egyptian legislative elections concluded in January 2012, the Democratic Alliance, a coalition of six parties led by the *FJP*, won 235 seats in the 508-member legislature. The *Ennahda* Movement in Tunisia won 41 percent of all votes and 89 seats in the 217-seat legislature in the 2011 elections. Following the elections in November 2011, in which it gained 107 seats out of 395, *Justice and Development Party* is the ruling party in Morocco. The three remaining cases are worth a separate discussion. The three Algerian religious parties formed the Green Algeria Alliance, an Islamic electoral bloc that gained 48 seats in the 463-member Algerian parliament. Unlike in other Arab Spring countries that in recent years held free elections, the turnout in the Algerian election was low and the election was viewed as rigged by the opposition, although accusations of fraud were not confirmed by international observers.<sup>172</sup> Likewise, the Islamic Action Front in Jordan boycotted the 2013 parliamentary elections as unfair.<sup>173</sup> Neither did the Brotherhood party fare well in the Libyan election of July 2012, in which the Justice and Construction Party received over 10 percent of the votes and 17 places in Libya's General National Congress, a key transitional body that is expected to appoint the new cabinet and an assembly to draft the new constitution. Libya's situation is complicated by the fact that none of the relevant political groups predate the fall of Gaddafi's regime and have any real grassroots presence. Furthermore, in the election, only one-third of the seats were allocated to political parties and two-third to individual candidates.

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<sup>172</sup> See African Union (2012).

<sup>173</sup> Seven IAF candidates ran as independent and were excluded from the party. Official voter turnout was 53 percent. See also Dunne (2010).

## 4.5 Conclusion

The purpose of this chapter was to present a parsimonious explanation for the popularity of Islamic parties in new and emerging democracies of the Middle East and North Africa. In our explanation, the rise of Islamic parties is an answer to the problem of credible pre-electoral commitment to the supply of public goods.

It should be stressed that this model does not purport to be *the grand theory* of religious politics. Notwithstanding the evidence that individual-level religiosity is a poor predictor of voting behaviour and also that individual-level religiosity does not map into specific policy platforms, we do not deny that some people in the Middle East and North Africa may also support religious parties because they attach importance to the religious zeal of Islamic candidates. Religion is undeniably an important part of culture and of *mētis* in Muslim-majority countries. But even if it were not, this chapter shows that there would be still strong reasons to expect Islamists to perform well in young Muslim democracies.

Our explanation thus makes a *ceteris paribus* claim. However, in the real world, other relevant variables are never constant. For our purposes, it means that the explanatory power of our story is weakened when there are other factors that lead to the alignment of voters with particular ideological platforms, e.g. when the population is split into factions along religious or ethnic lines. In the Middle Eastern context, this problem can be expected to be acute in places that suffer from a high degree of religious or ethnic polarisation, such as Lebanon, Bahrain or Iraq. In contrast, our explanation ought to fare well in more homogenous environments, where such divisions are small or non-existent – or where institutional mechanisms for the resolution of disputes between ethnic or religious groups exist.

The main implication of our stylised verbal model is that the presence of Islamic parties is welfare-enhancing relative to a situation in which politicians rely on patronage as the only method of making promises to voters. Unlike patronage-based politics, credible religious parties provide a bundle of public goods and transfers, maximising the utility of the median voter. Our account should not be read as an endorsement of political Islam, however. Our explanation is an abstract one and in its parsimony it assumes away a host of factors, including the ideological content of politics and goals of political leaders. The examples of Hamas and Hezbollah only serve to illustrate that, religious organisations, which are distinctly successful at providing club goods and local public goods, may also have an advantage in the sphere of organised violence.<sup>174</sup>

However that may be, in countries where the incentives for politically or religiously motivated violence are low,<sup>175</sup> the possibility of credible pre-electoral commitments raised by religious parties can improve the quality of the political process. These include countries where grievances can be voiced through political channels and conflicts can be settled through institutional means, or where such conflicts do not even arise – because of the underlying homogeneity of local populations. One can expect that the quality of governance is higher than in contexts where there is no one able to make credible promises. Comparatively, countries with no credible political groups, such as Libya, may face more difficulties than countries that do have religious parties – unless it uncovers an alternative way of addressing the problem of credible commitment. This also resonates with an earlier argument by Nasr (2005), according to whom a ‘Muslim’ democracy will be a necessary component of the transition of Arab countries to democracy.

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<sup>174</sup> Iannaccone and Berman (2006), Berman and Laitin (2008), Krueger (2007).

<sup>175</sup> Wintrobe (2006) provides a theoretical model of politically motivated violence that establishes the conditions under which terrorism will be the preferred mode of political action.

If one is worried by the rise of political Islam, it is worth stressing that one implication of our account is that the electoral advantage enjoyed by Islamic parties can be expected to dissipate over time as competing political groups establish channels of communication and promise verification for their voters, and build reputation over time. Obviously, this corollary of our model cannot yet be tested on data from Arab Spring countries. However, it seems to be in line with the pattern seen in other Muslim majority countries, which have liberalised their political process earlier on. Most notably, in Indonesia, the share of votes by Islamic parties has been falling since the elections in 1999 – from 39.2% in 1999, 38.4% in 2004, to 29.2% in 2009. If the political environment in the Middle East liberalises further, it will likely open new avenues for further research in the area of political Islam and its political economy dimensions, as well as new ways of testing more rigorously the explanation presented in this chapter.

## 5 Policy Preferences and the Czechoslovak Transition<sup>176</sup>

### 5.1 Introduction

Why did some post-communist countries embrace radical reform strategies, whereas others have followed longer and more roundabout paths towards markets? This chapter argues that differences in policy preferences and beliefs about markets – potentially reflecting the differences in *mētis*, a concept defined in Chapter 1 – might have played a role in shaping the institutions and policies adopted by governments of different transitional economies – of Slovakia and the Czech Republic.

A growing body of literature suggests that differences in institutions are associated with differences in beliefs and policy preferences displayed by individuals.<sup>177</sup> Much less is known about the drivers of differences in beliefs, in the absence of such *prima facie* variation in institutional characteristics. In this chapter, we study survey data from Czechoslovakia in the early 1990s and demonstrate that systematic differences existed between the policy preferences of Czechs and Slovaks - in spite of living in a common state and being exposed to similar policy shocks, institutional environment, and culture over a period of almost 75 years. On various questions in the Economic Expectations and Attitudes survey, covering the period of 1990-1993, the Czechs appeared more accommodative of the rapid transition towards the market economy, whereas the Slovaks retained a strong “anti-market bias.” For example, Slovaks were significantly more inclined to oppose the introduction of private health and social care, and were sceptical about the idea that capitalism was the only possible option for the future of Czechoslovak economy.<sup>178</sup> The differences in policy preferences between Czechs and Slovaks do not disappear after controlling for socio-economic status and other

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<sup>176</sup> A version of this chapter is currently under review in *Journal des économistes et des études humaines*.

<sup>177</sup> Alesina and Fuchs-Schündeln (2005), Di Tella, Galiani, and Schargrodsky (2007), Landier, Thesmar and Thoenig (2008).

<sup>178</sup> For more details, please refer to Table 5 below.



individual-specific observables, including self-reported ideology. Furthermore, they are robust to variation in different regional characteristics, such as past economic development or religiosity.

The existence of a Slovak “anti-market bias” seems puzzling. After all, the two Central European countries are alike in their culture, history, and challenges they are facing. A look at the current surveys of public opinion does not suggest a marked divergence of views on matters related to public policy. In 2009, for example, the average views on economic policy-related issues were aligned in the two countries, with Slovaks holding slightly more pro-market attitudes than the Czechs on most margins.<sup>179</sup> That suggest that even if the differences in ideology reported in this chapter reflected differences in the underlying *mētis*, it appears that such differences could be themselves subject to change over time.

This chapter distinguishes itself from the other case studies in this thesis by providing a novel emphasis on the role of beliefs in explaining divergent policy outcomes. Whereas the other studies in this thesis explore the notion of policy credibility issues emerging in transitional environments, the present paper investigates the implications of the possibility that beliefs themselves can be independent drivers of economic outcomes. By exploiting district-level variation in different characteristics, we assess several hypotheses that may explain the systematic differences in policy preferences: extent of the market in the pre-communist era, religiosity and also the structural characteristics of regions in the early 1990s. It turns out that the economic conditions of the early 1990s have a somewhat stronger explanatory power than the deeper historical characteristics of the two countries. Religiosity, for instance, does not seem to play a major role in explaining the variation in policy preferences across districts, although the share of protestant population is significant in some specifications. Inclusion of the 1994 district-

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<sup>179</sup> Table 15 in the appendix provides a summary of data from two waves of the Eurobarometer survey in 2009, which cannot sustain the claim that an anti-market bias existed on the part of the Slovaks in 2009.

level unemployment rate reduces the observed size of the Slovak “anti-market bias” somewhat but does not eliminate it altogether. This is consistent with the conjecture that the observed differences in opinions between the Czechs and the Slovaks might have reflected the expected asymmetry of costs involved in the transition towards a market economy, with Slovaks carrying a larger share of the burden of the transition.

Did policy preferences matter for the outcomes of the Czechoslovak transition? Given the identification issues a formal answer to this question would entail, we only provide a historical narrative of the political developments in the early phases of the economic transition, which were consistent with the underlying differences in ideology. The two parts of Czechoslovakia experienced very different political developments. In the Czech Republic, Václav Klaus and his radical pro-market platform became a leading political force. Simultaneously, in Slovakia, a political movement led by Vladimír Mečiar, who quickly ascended to power, displayed a much more cautious attitude towards markets and liberalisation. The differences in opinions about the desirable form of federalism within Czechoslovakia, together with divergent views of specific policy matters, led to the split of 1993. For most the 1990s, the two countries followed very different paths, both in terms of economic performance and policy making. The simultaneous occurrence of anti-market attitudes and anti-market policies in Slovakia does not establish a causal relationship, but it can be indicative of a link between policy preferences and policy outcomes. After all, beliefs are seen by an increasing number of researchers as the key factor affecting the institutional choices made by different societies,<sup>180</sup> including countries in transitions.<sup>181</sup>

At an intuitive level, cultural norms and beliefs may be important since they impose constraints on individual behaviour. Experimental evidence shows that cultural backgrounds are associated with different levels of cooperation in public goods

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<sup>180</sup> Eggertsson (2005), Denzau and North (1994).

<sup>181</sup> Pejovich (2003).

games.<sup>182</sup> At a microeconomic level, Di Tella et al. (2008) find an association between left-wing beliefs and crime victimisation. But can differences in beliefs be associated with any differences in aggregate economic outcomes? That seems to be the agenda behind the work by Douglass North (2007), who had stated that

it is much easier to describe and be precise about the formal rules that societies devise than to describe and be precise about the informal ways by which human beings have structured human interaction. But although they defy, for the most part, neat specification and it is extremely difficult to develop unambiguous tests of their significance, they are important. (North 1990: 36)

The idea that institutions are underpinned by a set of beliefs held by individuals living in a society is explored in North (2007). That beliefs – or ‘culture’ – might be an important factor shaping institutional and economic outcome seems to be confirmed by evidence as well. Tabellini (2010), for example, identifies an empirical link between cultural norms and economic outcomes, showing that pro-individualistic and egalitarian cultures are associated with higher levels of economic development.

Unfortunately, very little is known about the formation of beliefs and the specific mechanisms through which beliefs affect measurable outcomes. Di Tella and MacCulloch (2009) provide a partial explanation for the joint incidence of leftist beliefs, heavy regulation and corruption. In their setting, leftist beliefs are endogenous to the experience of ‘unpleasant’ capitalists and serve as a mechanism that reinforces heavy regulation that encourages further corruption. Obviously, there is a plethora of subtle explanations for the formation of preferences over policies – and the formation of beliefs about the effects of policies on economic outcomes, typically citing phenomena like rational ignorance,<sup>183</sup> rational irrationality<sup>184</sup> as well as the issue of individual identity.<sup>185</sup>

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<sup>182</sup> See, e.g., Gächter and Herrmann (2009). See also Esarey et al. (2012).

<sup>183</sup> Downs (1956).

<sup>184</sup> Caplan (2007).

One question is whether departures from Bayesian rationality are observed in the political realm and, if so, what is the significance of motivated beliefs, departing from the baseline neoclassical assumptions of cognitive rationality.<sup>185</sup> This chapter will not provide a compelling answer to the question of how beliefs about policies – or preferences over policies – are formed – in spite of a basic test of significance of individual socioeconomic status and various sources of regional variation.

Instead, the aim of the chapter is simply to outline a mechanism through which differences in beliefs and preferences over policy may have contributed, through different voting behaviour, to different policy outcomes in the two countries. This is in line with a burgeoning literature on the cognitive nature of institutional change, pioneered by North (2007) who claims that the fundamental reason for the adoption of institutions by different societies is the prevailing mental models.

Some authors, such as McCloskey (2013) or Mokyr (2010), go as far as to claim that the change in beliefs, and rhetoric about commerce or innovation, account for the economic rise of the Western world. Once entrepreneurship and innovation were regarded with approbation, more talented people turned towards the private sector, leading to the cluster of commercial innovation over the 18<sup>th</sup> and 19<sup>th</sup> century. The goal of this chapter is much more modest. Instead of presenting a ‘grand theory’ of the Czechoslovak transition, we merely try to make the case that differences in beliefs could have plausibly accounted for the different transitional trajectories of the Czech Republic and Slovakia.

This chapter is connected to a number of different works that look at the effects of institutions on beliefs and policy preferences. Besides scholars who have investigated

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<sup>185</sup> Akerlof and Kranton (2000).

<sup>186</sup> See Cowen (2003) for a discussion of mechanisms through which motivated beliefs can lead to political failure.

the changing demographic and societal landscape of transitional countries,<sup>187</sup> researchers have focused on the determinants of support for economic reforms.<sup>188</sup> Some of the findings suggest that private entrepreneurs, white-collar workers and university educated voters were generally supportive of the transition, whereas the unemployed, retirees, blue collar and agricultural workers opposed the reforms.<sup>189</sup> Similarly, scholars have investigated the sources of support for revising privatisation in transitional countries<sup>190</sup> or the effects of economic hardship on ideology and political attitudes.<sup>191</sup> In line with our own investigation – and using a part of the same dataset – Earle and Gehlbach (2003) find that receiving property through restitution was associated with support for economic reform and privatisation. Curiously, however, very little of the existing literature is focused on tracking systematic differences between countries or nations, or trying to explain those differences. Exceptions include the differences between citizens of the Soviet Union and the United States documented by Shiller, Boycko and Korobov (1991), the differences between former Soviet republics documented by Miller, Hesli and Resisinger (1994) or the wider Central and Eastern Europe documented by Rovelli (2009), Krkoska and Robeck (2008) or Runst (2012).

This chapter is organised as follows. Section 5.2 provides some historical background to our investigation and provides a discussion of our data sources. Section 5.3 presents estimation results and assesses alternative hypotheses about the drivers of Slovak anti-market attitudes in the early stages of transition. Section 5.4 provides a historical narrative explaining how differences in attitudes towards markets and economic and social policy affected the policy trajectories in the two countries. Section 5.5 concludes.

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<sup>187</sup> See, in the Czech context, e.g. Večerník (1992, 1997, 2002) or Machonin (1994).

<sup>188</sup> See, e.g. , Landier et al. (2008).

<sup>189</sup> Fidrmuc (2000).

<sup>190</sup> Denisova, Eller, Frye and Zhuravskaya (2007).

<sup>191</sup> Večerník (1995).

## 5.2 Background

With the exception of the wartime years 1939-1945, Czechoslovakia existed in various forms from 1918 until 1993.<sup>192</sup> In 1948, the Communist Party took over and the country became a part of the Soviet bloc, with a planned economy and a one-party political system. In 1989, the regime crumbled over a couple of weeks, as the violent repression of a student demonstration on 17 November in Prague triggered mass protests throughout the country. A swift change in the political leadership occurred, and a clear roadmap for the political and economic transition was drawn up by the new government. The cracks in the initial consensus over the direction of the country materialised quickly along the national lines. Ultimately, these differences culminated in the decision by the leaders of the two nations to divide the country into two.

The Czech Republic and Slovakia emerged as two sovereign countries on 1 January 1993, and followed different policy trajectories in the aftermath of the separation. The output slump in Slovakia was much deeper than in the Czech Republic, and the two countries also differed in the policies and institutions they adopted. For example, in the Czech Republic rapid and mass privatisation, including the second wave of voucher privatisation, was an important component of the reform process. In Slovakia, this second wave was cancelled (though the first wave of voucher privatisation had taken place earlier in the common state) and direct sales to domestic investors were the dominant privatisation method and they were used as a tool to build political support among potential party donors.<sup>193</sup> Thus, by 1995, the inward stock of FDI in Slovakia was close to just one sixth<sup>194</sup> of that in the Czech Republic.<sup>195</sup>

Although Slovakia's governing coalition, displaying anti-market and authoritarian tendencies, enjoyed public support, a broad group of opposition forces was able to

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<sup>192</sup> See, e.g., Heimann (2011) for an excellent, if revisionist, history of the Czechoslovak state.

<sup>193</sup> Haughton (2001: 749).

<sup>194</sup> United Nations Conference on Trade and Development (2001).

<sup>195</sup> See also Nellis (1999).

replace it in the general election of 1998. The new political representation later reclaimed Slovakia's place in the EU accession talks and proceeded with many of the overdue economic reforms – bank restructuring and privatisation, bankruptcy law, and the daring flat tax plan<sup>196</sup> which would turn Slovakia into a premier destination for foreign investors.<sup>197</sup>

Our data come from the survey *Economic Expectations and Attitudes* from years 1990-1993. We study six questions that in our view capture important dimensions of economic and social policy in the aftermath of the fall of communism – ranging from broad questions about the desirable economic system to specific queries about social policy, privatisation and health care – and which have the widest coverage throughout the different waves of the survey. The first question, *Money For Competent*, asks whether “[i]t is right that capable and competent people have a lot of money, even millions.” The second question, *Transform SOEs*, asks whether “[a]ll big state enterprises should be transformed into shareholders' companies or private firms.” Thirdly, *Only Capitalism* asks whether “[c]apitalism represents the only possible course of our future development.” Clearly, this is a broad and somewhat vague question, but the answers to it plausibly reflect the ideological positions of respondents and their beliefs about the desirable path for the economic transition. The fourth and the fifth question, *Private Social Services* and *Private Health Care*, ask about the respondents' attitude toward the privatisation of social services and health care. The exact wording of the questions is as follows: “Would it be right, according to your opinion, that a part of social care, e.g. care for the elderly, would be performed by private institutions?” and “would you agree with the introduction of private medical care? The sixth question, *Unnecessary Job Positions*, asks whether respondents agree with the statement that

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<sup>196</sup> Brook and Leibfritz (2005).

<sup>197</sup> On Slovak economic reforms, see the symposium with contributions from Marcinčin (2004), Chalupka (2004), Melicherčík and Ungvarský (2004), Marcinčin, Pažitný and Zajac (2004), Ciaian and Pokrivčák (2004), Studená (2004), Javorčík and Kaminsky (2004).

“[u]nemployment should be prevented even at the cost of preserving many unnecessary jobs.”

### 5.3 Policy preferences in the Czechoslovak transition

In this section, we provide evidence of systematic differences in policy preferences between the Czechs and the Slovaks in the early stages of the transition. We provide the results of linear regressions demonstrating that even after controlling for socio-economic status and ideology, Slovaks were less favourable of a transition towards the market than the Czechs. This section then tests various hypotheses about the origins of these differences. Unlike other sources of heterogeneity we are assessing, it appears that structural characteristics, namely the district-level unemployment rate in 1994, has some explanatory power for the evolution of beliefs.

Table 5 presents summary statistics of the six variables of interest in the Czech Republic and Slovakia, suggesting that systematic and significant differences in policy preferences existed between the Czechs and the Slovaks. Furthermore, those differences appear to be non-random, as they always go in one direction. On all six measures, Slovaks appear distinctly less enthusiastic about the market economy, income inequality, and market-based provision of healthcare and social services, and more apprehensive of the potential job losses involved in the transition.

Table 5 Differences in policy preferences between the Czechs and Slovaks

<i>Please note: Higher values indicate stronger pro-market attitudes. For the questions 1-5 below, the answers are coded as follows: 1 definitely no, 2 rather no, 3 rather yes, 4 definitely yes. For the question 6 below, the answers are coded as follows: 1 definitely yes, 2 rather yes, 3 rather no, 4 definitely yes</i>							
			<i>Mean</i>		<i>Coefficient on Slovak</i>	<i>Observations</i>	
	<i>Variable name</i>		<i>Czech</i>	<i>Slovak</i>			
1.	<i>Money For Competent</i>	It is right that capable and competent people have a lot of money, even millions.	3.08	2.78	-0.57***	10,830	
2.	<i>Transform SOEs</i>	All big state enterprises should be transformed into shareholders' companies or private firms.	2.67	2.40	-0.52***	10,760	



3.	<i>Only Capitalism</i>	Capitalism represents the only possible course of our future development.	2.54	2.20	-0.64***	9,130
4.	<i>Private Social Care</i>	Would it be right, according to your opinion, that a part of social care, e.g. care for the elderly, would be performed by private institutions?	2.90	2.58	-0.61***	10,812
5.	<i>Private Healthcare</i>	Would you agree with the introduction of private medical care?	3.24	2.84	-0.78***	10,828
6.	<i>Unnecessary Job Positions</i>	Unemployment should be prevented even at the cost of preserving many unnecessary jobs.	3.33	3.14	-0.46****	10,818

Coefficients from univariate ordered logit regressions against a *Slovak* dummy, \*  $p < 0.1$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

Slovaks were less willing to accept high earning of capable individuals (*Money For Competent*) and reported a weaker inclination to restructure or privatise state-owned enterprises (*Transform SOE*) and were more doubtful whether capitalism was the only possible outcome of the post-communist transition (*Only Capitalism*). In the same spirit, they were inimical about the prospects of private provision of health care and social services (*Private Social Services* and *Private Health Care*). Finally, they were also more inclined to fight unemployment by preserving unproductive jobs (*Unnecessary Job Positions*). Furthermore, as illustrated by the results of the univariate ordered logit regressions, these differences are statistically significant.

To see whether the differences between the Czechs and the Slovaks can be explained just by variation in individual characteristics like wealth, education or urbanisation, we introduce a selection of control variables into our analysis. To estimate the statistical association between policy preferences and various individual characteristics, we run six linear regressions, the results of which are reported in Table 6 below. The purpose of this exercise is to see whether the apparent differences in opinions reflect a self-serving bias, and whether the recorded pattern in responses has nothing to do with the wider societal characteristics, culture or expectations idiosyncratic either to the Czechs or the Slovaks. Furthermore, our estimation controls for the role of political ideology, as it

might have simply been the case that the Slovak part of the country was leaning more towards the Left than the Czech Republic.

Unlike in the univariate case, we use linear regressions instead of ordered logit. Provided that a large number of explanatory variables are categorical in nature, ordered logit or probit would provide potentially inconsistent estimates unless we have a large number of observations per each group.<sup>198</sup> To address to possible problem of correlation of standard errors, we cluster them by district (Okres).

Table 6 reveals that age is not a significant predictor of differences in policy preferences. Most importantly, the *Slovak* dummy is highly significant and has a sizeable coefficient. Income is weakly significant for some of the left-hand side variables but not for others. Higher levels of educational achievement are strongly associated with more pro-market attitudes. Unsurprisingly, self-reported political ideology is related to policy preferences in all specifications, and with the expected sign. What is somewhat more surprising is that the fact of being Slovak has a sizeable effect on policy preferences, both in terms of statistical significance and in terms of the size of the coefficient. That is true regardless of whether we include a vector of individual-specific dummies, such as variables controlling for political ideology, or whether we run a simple univariate regression, as reported in Table 5. The regressions reported in Table 6 also contain time-variant effects for different waves of the survey.

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<sup>198</sup> Greene (2008, p. 805).

Table 6 Linear regressions against a vector of individual characteristics, standard errors clustered by district

	(1) Money Competent	(2) For Transform SOEs	(3) Only Capitalism	(4) Private Social Care	(5) Private Health Care	(6) Unnecessary Job Positions
Age	0.006 (0.006)	-0.002 (0.005)	-0.007 (0.005)	-0.001 (0.004)	-0.003 (0.005)	0.012** (0.005)
Age2	-0.000*** (0.000)	-0.000 (0.000)	0.000 (0.000)	-0.000** (0.000)	-0.000 (0.000)	-0.000*** (0.000)
<b>Slovak</b>	<b>-0.271***</b> <b>(0.042)</b>	<b>-0.216***</b> <b>(0.033)</b>	<b>-0.276***</b> <b>(0.040)</b>	<b>-0.261***</b> <b>(0.041)</b>	<b>-0.382***</b> <b>(0.041)</b>	<b>-0.145***</b> <b>(0.031)</b>
LnIncome	0.006 (0.016)	0.018 (0.013)	0.025 (0.016)	0.002 (0.018)	0.042*** (0.014)	0.023* (0.013)
Married	-0.005 (0.031)	0.025 (0.039)	-0.067** (0.033)	-0.025 (0.041)	0.049 (0.031)	0.025 (0.035)
Divorced/W idow	0.025 (0.044)	-0.002 (0.051)	-0.024 (0.050)	0.044 (0.057)	0.022 (0.048)	-0.010 (0.048)
FinSecure	0.299*** (0.026)	0.150*** (0.031)	0.240*** (0.027)	0.188*** (0.032)	0.246*** (0.029)	0.175*** (0.024)
Left	-0.237*** (0.038)	-0.334*** (0.034)	-0.434*** (0.035)	-0.167*** (0.032)	-0.195*** (0.033)	-0.124*** (0.032)
Right	0.259*** (0.027)	0.250*** (0.031)	0.377*** (0.028)	0.253*** (0.028)	0.237*** (0.027)	0.176*** (0.024)
Above100	0.214*** (0.044)	0.009 (0.040)	0.148*** (0.042)	0.096*** (0.035)	0.112*** (0.034)	-0.011 (0.040)
Above20	0.103** (0.041)	-0.009 (0.036)	0.081* (0.044)	0.047 (0.043)	0.104*** (0.040)	0.034 (0.034)
University	0.374*** (0.039)	0.086** (0.043)	0.124*** (0.042)	0.127*** (0.033)	0.366*** (0.033)	0.341*** (0.033)
HighSchool	0.294*** (0.034)	0.081*** (0.031)	0.085*** (0.028)	0.105*** (0.030)	0.278*** (0.030)	0.300*** (0.029)
Vocational	0.147*** (0.027)	0.076*** (0.029)	0.058** (0.027)	0.062** (0.029)	0.127*** (0.027)	0.124*** (0.028)
Male	0.133*** (0.023)	0.073*** (0.022)	0.073*** (0.022)	-0.095*** (0.019)	-0.018 (0.021)	0.078*** (0.020)
Wave effects	Yes	Yes	Yes	Yes	Yes	Yes
N	6959	6920	6933	6951	6958	6954

\* p<0.1 \*\* p<0.05 \*\*\* p<0.01

Why do we observe a consistent anti-market pattern in the attitudes reported by Slovak respondents, which cannot be explained by variation in the observed individual-specific

characteristics? Several explanations are available, although discriminating between them is problematic.

First, the differences in attitudes between the Czechs and the Slovaks could be explained by deeper differences in legal origins, institutional histories and culture between the two countries, which would date back to the era before the foundation of Czechoslovakia. Unfortunately, such hypothesis is not testable as it would require a larger sample of countries than just the Czech Republic and Slovakia.

Another option is that the differences in beliefs were not driven by differences between the Czech Republic and Slovak but rather by variation at the local level. Specifically, we test whether pre-communist levels of economic development and market size affect the left-hand side variables. To test that hypothesis we exploit the variation between Czech and Slovak districts (Okresy).

Among the various explanatory variables that were tried in various specifications (not reported here) is a Prague dummy. Clearly, Prague had long been a sizeable economic and cultural centre, so one may hypothesise that it was driving at least some of the differences between the two countries. While significant in some specifications, it has little explanatory power. We have also used two measures correlated with the level of overall economic development before the communist era - namely geographic distance (using available roads) from the former royal capital, which was Prague in the case of the territory of the modern Czech Republic, and Budapest in the case of modern Slovakia. Distance from the capital is significant in most regressions. However, its inclusion does not much change the size of the coefficient on *Slovak*, suggesting that its explanatory power is limited. Likewise, the population of the capital city of the district in 1880 has only a very small explanatory power in accounting for the differences in beliefs.

Finally, regions that had to undergo a deeper and more painful economic adjustment during the transition and the individuals living in those regions could have plausibly been more opposed to economic reforms, even after controlling for their own socio-economic status. We proxy for the depth of the transitional economic adjustment by district-level unemployment in 1994. We use the year 1994 because in that year the cross-district variance in unemployment rates was the highest from all of the periods under consideration. While unemployment is not an encompassing measure of the transitional costs, it is illustrative. Regional differences in former Czechoslovakia were – and still remain – significant. In 1994, many of the Slovak districts found themselves with unemployment exceeding 20 percent, whereas unemployment in all of the Czech districts was in single digits.

Table 7 provides the results of a joint test of a variety of different explanations for the Slovak “anti-market bias,” including district-level measures of religiosity and Protestantism. We have also included these alternative explanations into regressions one by one, without producing qualitatively different results. The main finding revealed in Table 7 is that the *Slovak* dummy does not become insignificant in five out of six specifications, although its size and significance is reduced somewhat. This suggests that the available local sources of variation are not successful in accounting fully for the observed differences in attitudes between the Czechs and the Slovaks.

Table 7 Linear regressions, including a variety of alternative explanations, standard errors clustered by district.

	(1) Money For Competent	(2) Transform SOEs	(3) Only Capitalism	(4) Private Social Care	(5) Private Health Care	(6) Unnecessary Job Positions
Age	0.006 (0.006)	-0.002 (0.005)	-0.002 (0.005)	-0.002 (0.004)	-0.003 (0.005)	0.012** (0.005)
Age2	-0.000*** (0.000)	-0.000 (0.000)	-0.000 (0.000)	-0.000** (0.000)	-0.000 (0.000)	-0.000*** (0.000)
<b>Slovak</b>	<b>-0.171**</b> <b>(0.080)</b>	<b>-0.066</b> <b>(0.065)</b>	<b>-0.066</b> <b>(0.065)</b>	<b>-0.160**</b> <b>(0.074)</b>	<b>-0.207***</b> <b>(0.065)</b>	<b>-0.073</b> <b>(0.066)</b>
LnIncome	0.007 (0.016)	0.020 (0.013)	0.020 (0.013)	0.005 (0.017)	0.043*** (0.014)	0.025* (0.013)
Married	0.001 (0.031)	0.030 (0.039)	0.030 (0.039)	-0.019 (0.040)	0.053* (0.032)	0.028 (0.035)
Divorced/ Widow	0.021 (0.044)	-0.004 (0.050)	-0.004 (0.050)	0.040 (0.056)	0.017 (0.047)	-0.013 (0.048)
FinSecure	0.295*** (0.026)	0.147*** (0.031)	0.147*** (0.031)	0.185*** (0.032)	0.240*** (0.029)	0.171*** (0.024)
Left	-0.238*** (0.038)	-0.335*** (0.033)	-0.335*** (0.033)	- 0.170*** (0.033)	-0.197*** (0.033)	-0.124*** (0.032)
Right	0.252*** (0.026)	0.249*** (0.031)	0.249*** (0.031)	0.250*** (0.028)	0.232*** (0.026)	0.172*** (0.023)
Above100	0.114** (0.049)	-0.050 (0.044)	-0.050 (0.044)	0.030 (0.059)	0.003 (0.045)	-0.022 (0.070)
Above20	0.116*** (0.039)	-0.004 (0.035)	-0.004 (0.035)	0.058 (0.044)	0.114*** (0.039)	0.038 (0.034)
University	0.375*** (0.039)	0.084** (0.042)	0.084** (0.042)	0.124*** (0.033)	0.367*** (0.033)	0.343*** (0.033)
HighSchool	0.291*** (0.034)	0.081** (0.031)	0.081** (0.031)	0.103*** (0.030)	0.276*** (0.030)	0.300*** (0.029)
Vocational	0.145*** (0.027)	0.076*** (0.029)	0.076*** (0.029)	0.061** (0.029)	0.126*** (0.027)	0.123*** (0.028)
Male	0.134*** (0.023)	0.073*** (0.022)	0.073*** (0.022)	- 0.095*** (0.019)	-0.017 (0.021)	0.079*** (0.020)
<b>Prague</b>	<b>0.033</b> <b>(0.124)</b>	<b>0.069</b> <b>(0.152)</b>	<b>0.069</b> <b>(0.152)</b>	<b>0.077</b> <b>(0.142)</b>	<b>-0.066</b> <b>(0.122)</b>	<b>0.275*</b> <b>(0.151)</b>
<b>Unemployment 1994</b>	<b>-0.013**</b> <b>(0.005)</b>	<b>-0.010**</b> <b>(0.004)</b>	<b>-0.010**</b> <b>(0.004)</b>	<b>-0.010**</b> <b>(0.005)</b>	<b>-0.015***</b> <b>(0.005)</b>	<b>-0.005</b> <b>(0.004)</b>
<b>Industry</b>	<b>-0.294</b> <b>(0.233)</b>	<b>-0.030</b> <b>(0.230)</b>	<b>-0.030</b> <b>(0.230)</b>	<b>-0.046</b> <b>(0.280)</b>	<b>-0.388</b> <b>(0.257)</b>	<b>-0.002</b> <b>(0.265)</b>
<b>PopCap1880</b>	<b>0.004</b> <b>(0.009)</b>	<b>-0.003</b> <b>(0.011)</b>	<b>-0.003</b> <b>(0.011)</b>	<b>0.001</b> <b>(0.011)</b>	<b>0.003</b> <b>(0.009)</b>	<b>-0.015</b> <b>(0.012)</b>

<b>DistCap</b>	<b>-0.304</b> (0.290)	<b>0.030</b> (0.238)	<b>0.030</b> (0.238)	<b>-0.173</b> (0.336)	<b>-0.293</b> (0.293)	<b>-0.379</b> (0.271)
<b>Religiosity</b>	<b>0.253</b> (0.198)	<b>-0.149</b> (0.200)	<b>-0.149</b> (0.200)	<b>0.049</b> (0.212)	<b>0.058</b> (0.181)	<b>0.079</b> (0.169)
<b>Protestant Share</b>	<b>-0.170</b> (0.370)	<b>0.097</b> (0.419)	<b>0.097</b> (0.419)	<b>0.725</b> (0.465)	<b>-0.645</b> (0.530)	<b>-0.519</b> (0.416)
Wave effects	Yes	Yes	Yes	Yes	Yes	Yes
N	6959	6920	6920	6951	6958	6954

p<0.1    \*\* p<0.05    \*\*\* p<0.01

## 5.4 Popular attitudes and Czechoslovak transition

We do not formally test the hypothesis that differences in ideology *caused* different policy outcomes in the two countries – that exercise is doomed by the small sample size, with the relevant variation occurring between two countries, and no obvious instrumental variables available. Instead, we provide a historical narrative of the political developments of the early 1990s, which is consistent with that conjecture.

Clearly, that does not allow us to rule out alternative explanations by a sleigh of hand, partly because the two countries differed in a number of characteristics that may have affected both the prevailing ideology and the policy outcomes. One thinks particularly of the initial economic conditions, as well as the structure of the two economies. However, while it has been demonstrated that initial economic conditions can go a long way in explaining the length and severity of economic recessions during the early phases of transitions,<sup>199</sup> it is not clear that they can explain the different policy choices made in the two countries. First, our results show that they do not account for the differences in market attitudes between the Czechs and the Slovaks. And, second, our narrative presents *prima facie* evidence for the popular appeal of different policy platforms selected in the Czech Republic and Slovakia. Indirectly, therefore, our

<sup>199</sup> Heybey and Murrell (1999), Krueger and Ciolko (1998), Åslund, Boone and Johnson (1996).

account is incompatible with a perspective that stresses economic differences as the prime mover of ideology and/or policy choices.

True, the structural and economic differences could have affected the policy-making process in Czechoslovakia by routes other than through popular attitudes. Most importantly, the different economic structures could have given rise to different coalitions of interest groups, which either supported or opposed the transition, and which clashed in the years following 1989. But such an approach would have to explain the unequivocal popular appeal of the radically different policy platforms in the two parts of Czechoslovakia.

#### **5.4.1 A brief history of economic reforms in Czechoslovakia in the 1990s**

At the time when communist regimes fell in Eastern Europe, Czechoslovakia was among the most rigid and sclerotic regimes in the region. The era following the Soviet invasion of 1968 was marked by a high degree of homogeneity in the party leadership and by a remarkable fear of change and reform.<sup>200</sup> As a result, in 1989 the Czechoslovak economy resembled most closely to the original Soviet planned system. Whereas, for instance, Hungary's economy – dubbed also the 'Goulash Communism' – did include features of market based allocation of resources and private enterprise, Czechoslovakia possessed the smallest private sector outside of the Soviet Union, with only 0.7 percent of the GDP contributed by private non-farm enterprises.<sup>201</sup>

At a political level, the transition was swift, complete and credible. Following the regime's repression of a student demonstration, a popular mobilisation ensued, which brought formerly isolated dissident leaders into leadership positions. Through a series of talks between the communist nomenklatura and opposition activists led by Václav Havel, a quick transfer of power was negotiated, and a new "government of national

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<sup>200</sup> See Linz and Stepan (1996).

<sup>201</sup> Mejstřík and Burger (1994: 136).



understanding” was formed under the premiership of Marián Čalfa, a lawyer and a former communist official. Within a month, the former official power structures were made irrelevant for any decision-making, and were replaced by newly emergent party structures in the form of the Civic Forum (OF) and its Slovak counterpart, the Public Against Violence (VPN).<sup>202</sup>

Although the nature of the political change was universally accepted, there was less agreement over the nature of the economic reform. As a result of the power structure emerging in the country, the key transitional debates took place not between the old party leadership and the opposition, but between various intellectual groups within the opposition, which had acceded to power. Hardoš (2009) provides a discussion of these particular groups. Most prominently, they included the radical reformers led by the federal finance minister Václav Klaus. That group comprised of Karel Dyba, Tomáš Ježek, Dušan Tříška and the young Vladimír Dlouhý. Their main opponents were a small group of former communist reformers who had fallen out of favour with the regime after the Soviet invasion in 1968. This latter group was led by Valtr Komárek, former head of the Prognostics Institute at the Czechoslovak Academy of Sciences and deputy prime minister for economy in Čalfa’s government. In actual political dealings, Komárek was sidelined by the more apt Klaus, who proposed his own conception of economic reform in April 1990. Klaus’ conception had no politically viable alternative, as Komárek was unable to formulate his own reform agenda in the meanwhile. The relevant alternative was a proposal for a sequenced reform, put forward by František Vlasák, former Czechoslovak minister of planning in the Prague Spring year of 1968. This alternative proposal differed mainly in its views on privatisation, which was to be done only gradually – in sharp contrast to Klaus’ programme which stipulated that privatisation needed to proceed quickly. In May 1990, Klaus’ programme was adopted

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<sup>202</sup> Hardoš (2009) provides an excellent account of the power struggle surrounding the decisions over the economic reform, from which we are drawing in this section.

by the Federal government, while incorporating a small number of ideas from Vlasák's plan.

The election in June 1990 gave a strong mandate to OF – and to VPN – to proceed with their reform agenda, which they did. Price liberalisation was started on 1<sup>st</sup> January, 1991, resulting in a temporary spike in inflation, counteracted by the central bank's anti-inflationary measures, coupled with fiscal austerity that was seen as an important component of inflation-taming policies. At the same time, foreign trade was liberalised, and currency convertibility was restored. Throughout 1991, the programme of 'small privatisation' was being implemented through a large number of small auctions aiming at transferring ownership of small businesses into private hands. At the same time, the preparations for the large-scale voucher privatisation were on their way. Much in the spirit of Rodrik's (1988) idea of overshooting, Klaus' reform agenda avoided the problem of policy credibility, which plagued some of the reform initiatives elsewhere in the post-communist space. By adhering to an ambitious reform programme early on, the government signalled to the population – both in the Czech and in the Slovak part of the country – that there was a determination to fundamentally change the institutions governing economic life in the country.

It is worth stressing that in spite of a clear policy direction imposed by Klaus and its credibility, this was an era of heated discussions and disagreements, especially on the Slovak side. As a matter of fact, Klaus' reform team was composed primarily of Czech economists, who had belonged to the same Prague circles. Their ideas never found much traction in Slovakia, where a different mode of thinking about the markets and the economy was more common. While the OF and the VPN shared some structural similarities as political entities emerged in the turmoil of the Velvet Revolution, the Slovak mutation was more ideologically diverse than the OF. By its name alone, VPN implied a limited political agenda – namely an end to the 'violence' exercised by the

regime – whereas OF was more open-ended about its ambitions in forming policy. Krapfl (2009) shows that the VPN emerged as a distinctly Slovak counterpart to the OF, leading to the demise of many locally formed bureaus of the OF, which emerged in the immediate aftermath of November 17.

Many reform communists, including economists such as Hvezdoň Kočtúch or Augustín Marián Húska were co-opted into the new political movement, alongside the living symbol of the Prague Spring, Alexander Dubček. Unlike their counterparts in the Czech part of the country, Slovak intellectuals were taking seriously the idea of a “third way” between communism and capitalism. Hardoš (2009) reports that even before the formulation of Klaus’ reform proposal, a small group of Slovak economists published their own conception of the reform. Entitled “The suggested conception of a Czecho-Slovak federation under the conditions of the market mechanism,” and published in the *Slovak Literary Weekly*.<sup>203</sup> The essay is characteristic for its commitment to seeking a third way between capitalism and socialism, which would be suited to Slovak economic interests. The question of constitutional arrangement for the two republics was seen as critical for the “synergy of economic mechanisms,” which could be achieved only in an “authentic federation.” Although the paper is short on specific proposals, it is obvious that it does not see the transition towards market economy as desirable. Instead of being privatised, state-owned companies were to become “emancipated” and “socially owned.” The resulting pluralism of ownership forms would bring about a “symphony of effectiveness” by connecting “the individual, the enterprise, the communal, the national, the private and the mixed forms of ownership by the criteria of resulting synergy.” (Kočtúch et al., 1990: 13)<sup>204</sup>

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<sup>203</sup> Kočtúch et al. (1990).

<sup>204</sup> See also Hardoš (2009: 48-49).

#### 5.4.2 The Velvet Split and the Czechoslovak divergence

While it would be easy to dismiss the ramblings by Kočtúch et al. as inconsequential, they reflected a broader collective mood in the country, as indicated by the survey results reported in the previous section.

That mood did have consequences. In early 1991, the VPN began to disintegrate. In May, a new Movement for Democratic Slovakia, led by former Slovak prime minister, Vladimír Mečiar, and his former colleagues from VPN, was registered as a political party in the country. Within months, it would become the dominant political force, perceptive of the nationalist undertones in Slovak debates, as well as to the existing anti-market bias. HZDS would not be a party that could be pinned down easily in ideological terms – rather, it represented a catch-all organisation, with a mix of policies and platforms to garner every available constituency, without any regard for consistency. We can see it as a rally party, unified by a fuzzy self-identification as the defender of “Slovakia’s interests.”<sup>205</sup> Thus the HZDS and its electoral manifesto were representative of the market attitudes prevailing in the country. What is more, it also reflected the turn taken by effective policy making in the country, as can be manifested by programme declarations of Mečiar’s 1992 and 1994 governments.<sup>206</sup>

In its 67-page electoral manifesto,<sup>207</sup> Mečiar’s party did not oppose a transition from a centrally planned economy. However, in line with the popular views in the country, it developed a programme of slow, cautious transition, which succeeded in attracting wide popular support. Indeed, the document, with its series of rambling decalogues for policy areas ranging from macroeconomic stability, workers’ living conditions, energy, to culture and IT, tries to be everything to everyone. Furthermore, in spite of its clearer language, it is not difficult to detect the intellectual influence of Kočtúch and his co-

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<sup>205</sup> Innes (1997), Haughton (2001).

<sup>206</sup> Government of the Slovak Republic (1992, 1994).

<sup>207</sup> Movement for Democratic Slovakia (1992).

authors, some of whom pursued political careers within the structure of the HZDS and who provided significant input into the document.

The basic premise of the manifesto is that a satisfactory functioning of the free market could not be attained in the short run,<sup>208</sup> hence government regulation of the economic process was necessary throughout the transition period. The manifesto, alongside with later programme declarations of the 1992 and 1994 governments, emphasise sector- and region-specific industrial policies. Liberalisation of prices and wages was to be gradual and, more importantly, the prices – which were liberalised in 1991 by the Klaus government – were to be re-regulated by adopting a set of “overall regulatory rules in the area of prices.” (p. 23). In sharp contrast to Klaus’s emphasis on prudent fiscal and monetary policy, the manifesto promised to restore the aggregate demand in the economy, damaged by the output contraction of the early 1990s.<sup>209</sup> Mečiar’s party also planned to “reconsider the process of voucher privatisation, because of the risk of a cheap sale of national wealth abroad, and the risk of concentrating wealth in the hands of a small number of owners.”<sup>210</sup> (p. 23)

The manifesto had a strong welfare dimension, with promises of state-guaranteed minimal conditions of living for workers’ families (p. 57), an explicit reference to the papal encyclic “Centesimus Annus,” (p. 5) – although HZDS was never an explicitly religious party – and promises of indexation of various entitlements to inflation.

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<sup>208</sup> Ibid.: 22).

<sup>209</sup> This is reflected in the 1992 and 1994 Programme Manifestos of the Slovak Government: “Development policies will form the basis of macroeconomic strategy, instead of the broadly applied restriction, which led to the decline in otherwise promising sectors of the economy.” (Government of the Slovak Republic, 1992: 8). “Reviving the economy necessitates transitioning away from a restrictive policy towards an expansionary one.” (Government of the Slovak Republic, 1994: 12)

<sup>210</sup> One finds similar wording in 1992 Programme Declaration of the Slovak Government, which stresses “the specificities of sectoral economies, emerging characteristics of individual regions and situation on individual markets” which warrant “government participation in strategic sectors [of the economy].” (Government of the Slovak Republic, 1992: 13) Moreover, “[The government] will minimise the risk of cheap sales of national wealth abroad and an undesirable concentration of ownership.” (Government of the Slovak Republic, 1992: 14)

While other political forces – most notably the Slovak National Party (SNS) – were catering to the fringe nationalist electorate, Mečiar was astute in garnering popular support for his platform revolving around some idea of Slovak exceptionalism and his personal charisma. In the 1992 elections to the Slovak Parliament, Mečiar’s party received more than 37 percent of all votes, and entered into coalition with the nationalist SNS. HZDS was also the front runner in the elections to the federal chambers, which were held simultaneously.

In early 1991, the OF started to disintegrate as well. In April 1991, Klaus founded the Civic Democratic Party (ODS), which then grew into the leading political group in the Czech Republic. The ODS was running on a platform of market liberalism and a radical departure from the practices of the communist era. ODS’ electoral manifesto thus stated that “it is the individual – and not the government – that is the foundation of economic prosperity, as he is the embodiment of economic activity and initiative.”<sup>211</sup>

The manifesto articulated private property, freedom of contract and free markets as the essential principles of its economic policy, which revolves around the idea of complete privatisation of “all state-owned enterprises and state institutions, with the exception of those that provide public goods.” The ODS pledged to continue with rapid privatisation, price and wage liberalisation, balancing the budget and an opening up to foreign investment. Klaus’ message resonated among the Czechs, and in the 1992 elections, the ODS would become the leading political party in the country, entering into a right-wing coalition with a number of small conservative and Christian parties. Unlike its Slovak counterpart, the 1992 Czech government had the nominal ambition to accelerate, and not to decelerate, the process of transition towards the market economy: “The government considers the current momentum and speed of economic reforms to be the

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<sup>211</sup> Civic Democratic Party (1992).

lower bound of what is necessary for its continuation and effectiveness.” (Government of the Czech Republic, 1992: 5)<sup>212</sup>

Unsurprisingly, the differences between the two leading political parties were congruent with the observed differences in attitudes towards markets and economic and social policy, documented in this chapter. HZDS’s electoral manifesto, just like the Slovak public at large, was more inclined to display the following features:

- A lack of appreciation for economic logic. The manifesto implies that wage increases can be by themselves drivers of inflation.<sup>213</sup> It also implies that modern economies need to be focused on manufacturing final, rather than intermediate goods, and that they should use domestic resources as opposed to resources that need to be imported.<sup>214</sup>
- A sense of entitlement and egalitarianism. “The right of a person to work is an essential human right.”<sup>215</sup> The manifesto is against any increases in the retirement age<sup>216</sup> and stipulates that the government will remain involved in the area of social policy even after the transition.<sup>217</sup> According to the manifesto, economic policy needs to take into consideration the social dimension of the transition and “accept the limits of what is socially tolerable. It is impossible to rely solely on self-regulating capacity of markets and expect the public to bring major sacrifices.”<sup>218</sup>
- Economic nationalism. The manifesto suggests temporary use of trade barriers, until Slovak companies become competitive.<sup>219</sup> Its case against voucher

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<sup>212</sup> The 1992 programme declaration of Klaus’ government also commits to fiscal restraint (Government of the Czech Republic, 1992: 6), and privatisation and fostering of markets as the main instruments promoting structural change. (ibid.: 8)

<sup>213</sup> Movement for Democratic Slovakia (1992:8).

<sup>214</sup> Ibid.: 22.

<sup>215</sup> Ibid.: 2.

<sup>216</sup> Ibid.: 3.

<sup>217</sup> Ibid.: 2.

<sup>218</sup> Ibid.: 5.

<sup>219</sup> Ibid.: 8.

privatisation is partly built on the concern over selling Slovak national assets cheaply to foreigners.<sup>220</sup>

Let us recall that although HZDS was the leading political force ahead of the 1992 election, Slovaks had a choice between a number of different policy platforms, including ODS' Slovak franchise, the DS. That one, however, earned only a miniscule number of votes in the 1992 elections. At the time of the elections, it was becoming increasingly obvious that a simple continuation of the common state with the Czechs was impossible. This was due mainly to the divergence in the political platforms of the two leading parties in the Czech and Slovak parts of the country. After weeks of negotiations, a split of the country was agreed upon between Mečiar and Klaus.

To a large extent, the rest is history. The Czech Republic and Slovakia emerged as two sovereign countries on 1 January 1993, and they followed different trajectories in the immediate aftermath of the separation. Firstly, the output slump in Slovakia was deeper than in the Czech Republic. This might have owed more to the poorer initial conditions and structure of the Slovak economy than to specific policy moves. However that may be, the period between 1992 and 1994 was marked by a halt of the privatisation process in the country, and then, after 1994, by a lack of restructuring even among the privatised companies.<sup>221</sup> In contrast, throughout most of the 1990s, the Czech Republic was perceived as the economic success story of the post-communist world, in spite of the recession and a banking crisis that hit in late 1996. Secondly, Slovakia's commitment to democracy and limited constitutional government was in question for a large part of the 1990s, as Mečiar's government was implicated in a variety of scandals, ranging from corrupt privatisation practices to a case of abduction of the President's son.

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<sup>220</sup> Ibid.: 7.

<sup>221</sup> Beblavý (2010: 4-5).



Mečiar's attitude towards privatisation was peculiar. It was used as a tool to build political support among potential party donors; hence around 80 percent of the total number of SOEs were privatised during Mečiar's era (Haughton, 2001: 749), although the government kept the commanding heights of the economy, including the gas and electricity companies, utilities and the banking sector. As illustrated in the 1992 manifesto, HZDS had a reserved attitude towards privatisation by foreign investors – a factor that arguably contributed to less-than-ideal outcomes in the area of corporate governance and enterprise performance.<sup>222</sup>

Although Mečiar enjoyed public support, the collective mood in Slovakia began to change in the second half of the 1990s. In the general election of 1998, conducted in an almost revolutionary atmosphere, Mečiar lost office to a wide coalition of pro-EU parties who would later reclaim Slovakia's place in the accession talks and who would also proceed with numerous economic reforms – bank restructuring and privatisation, bankruptcy law, and eventually with the daring flat tax plan, which would turn Slovakia into a premier destination for foreign investors.

Interestingly, while in the early 1990s Slovaks displayed a significant degree of scepticism about rapid pro-market reforms, in the 2000s the Slovaks earned themselves the reputation of being among the most zealous reformers in Central and Eastern Europe – pioneering the flat tax, for instance,<sup>223</sup> or moving towards a privatisation of social security.<sup>224</sup>

## **5.5 Conclusion**

This chapter demonstrates that Czech and Slovak policy preferences differed widely in the aftermath of the fall of communism. On a variety of survey measures, Slovaks had a strong and consistent aversion against the market and private enterprise.

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<sup>222</sup> Nellis (1999).

<sup>223</sup> Brook and Leibfritz (2005).

<sup>224</sup> Goliaš (2004).

Why was that the case? Explanations that rely on variation in historical features of the two societies, such as the religiosity or extent of the market or degree of remoteness or proximity to major urban centres, seem to bear only a weak relationship to the observed differences in beliefs. Similarly, explanations that use variation in collective memory of the pre-communist era do not appear to be consistent with the data, although our proxies for something as effusive and delicate as “collective memory” are imperfect. Economic structure, measured by 1994 district-level unemployment, seems to be related to the observed measures of market-related beliefs but does not account for the observed Slovak anti-market bias. The Czech part of the country and Slovakia were subjected to the same initial policy shock in the early 1990s – the ambitious economic reform programme devised by the federal government. For that reason, it would be difficult to explain the differences in subsequent policy trajectories of the two countries by, say, different degrees of credibility of the reform programme. However, it is conceivable that people in the two parts of the country had different perceptions of the possible effects of reforms – and that there was an asymmetry in the expectations of costs and benefits that a radical reform process would generate.

The historical narrative provided in this chapter is consistent with the conjecture that differences in attitudes towards markets and economic and social policy were driving the events that led to different policy outcomes in the two parts of the country. An important avenue for future research would consist of showing formally that policy preferences and beliefs about markets matter for institutional and economic outcomes or for public policy. That is a difficult exercise, given the nature of identification problems involved. While we do not offer such identification strategy, we are tempted to argue that the causal link between beliefs and policy preferences on the one hand and economic, institutional and policy outcomes on the other hand, is plausible, and perhaps necessary if we are to advance our understanding of institutional change or policy reforms.

## 6 Conclusion

This thesis attempts to establish that two, largely understudied, factors affect the outcomes of policy changes and transitions. Firstly, efficiency-enhancing policy changes may not occur if policymakers pursue self-interest instead of public interest, and if mechanisms aligning self-seeking behaviour and public interest are weak. Incentive problems in politics can take many different forms, and may affect voters, policymakers, or bureaucrats charged with implementing a policy change. This thesis has focused on a particular category of incentive problems – namely on problems of credibility. Policies can be understood as contracts between the population and policymakers. And just like private contracts, they are based on promises that can be broken. How the risk of reneging on promises affects the set of possible policy outcomes or the characteristics of the political arena constituted one basic set of questions that this thesis purports to address.

Secondly, measurable differences in policy preferences – or in the prevailing beliefs about effects of economic policies – affect outcomes of changes in policies, as does the knowledge available to voters and policymakers. This issue is part of a broader set of questions of how much ‘cognitive’ and ‘behavioural’ limitations, and the set of underlying cultural norms, practices and expectations – *mētis* – affect the outcomes of changes in policies and formal institutions. One of the chapters in this thesis attempted to study, on the example of the economic transition in Czechoslovakia, the role that collective beliefs play in economic and political transitions.

Before discussing the specific implications of the three case studies, it is worth recalling that in the review of literature on post-communist transitions in Chapter 1 we established the following four regularities:

- (1) Successful reform strategies focus on controllable variables, as opposed to factors that are out of policymakers' reach;
- (2) Policymakers should focus on a small number of known and measurable variables, as opposed to a large number of complex variables, the interactions of which they might not fully understand;
- (3) Credibility matters. Successful reform strategies in transitional environments must be able to overcome the problem of the lack of credibility. Speed, completeness of changes, and their irreversibility seem to achieve that; and
- (4) Initial conditions matter. Besides differences in levels of economic development, institutional, legal and political legacies, transitional economies differed in the preferences, beliefs and mental models of the general public.

The findings of the three case studies presented in this thesis are consistent with those initial findings, particularly with points (3) and (4). In Chapters 3 and 4 we identify credibility as being not only a factor affecting the outcomes of economic policies but also shape the political landscapes in countries of the Middle East and North Africa, in a way that is consistent with the public choice literature on policy credibility. Chapter 5, in turn, documents that differences in beliefs about economic policy and differences in policy preferences between the Czechs and the Slovaks in the early 1990s were associated with the differences in public policy outcomes that prevailed in the countries. Without pretending to solve the problem of identifying the direction of causality, it is our hope that this finding will serve as an impetus for future research seeking to establish causal links between beliefs on the one hand and policy outcomes on the other, particularly in the context of transitional economies. In the remainder of this concluding chapter, we provide some practical implications of our three case studies.

## 6.1 Credibility and subsidy reform

Chapter 3, discussing the political economy of subsidy reform in Egypt has the largest potential for generating specific, practical policy implications. It is probably also the chapter with the greatest practical relevance for the immediate economic and fiscal problems plaguing Egypt. This is because excessive subsidy spending is arguably a contributing factor towards the country's chronic fiscal deficit problem, which will need to be tackled quickly in order to return Egypt's public finances on a sustainable path. As an International Monetary Fund brief put it, "[a] priority will be to implement upfront measures to begin reducing the fiscal deficit and ensure a credible, sustainable medium-term fiscal trajectory." (IMF 2012, p. 7)

As stated in the conclusion of Chapter 3, a credible reform of subsidies will need to be (1) complete, quick, and simple to implement, (2) accompanied by a compensation scheme directed at those segments of the population who are deriving net benefits from existing subsidies, and (3) accompanied by reforms that would improve the functioning of markets in commodities that are being subsidised. In some respects, these recommendations are consistent with the conclusions of different studies that have synthesised the lessons from subsidy reforms around the world.<sup>225</sup> However, putting

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<sup>225</sup> See, e.g. Vagliasindi (2012), World Bank (2005), Coady et al. (2010), Commander (2012). The IMF (2013) has recently revisited reforms in 22 different countries and summarised the key elements of a successful reform as follows:

"(i) [A] comprehensive energy sector reform plan entailing clear long-term objectives, analysis of the impact of reforms, and consultation with stakeholders; (ii) an extensive communications strategy, supported by improvements in transparency, such as the dissemination of information on the magnitude of subsidies and the recording of subsidies in the budget; (iii) appropriately phased price increases, which can be sequenced differently across energy products; (iv) improving the efficiency of state owned enterprises to reduce producer subsidies; (v) targeted measures to protect the poor; and (vi) institutional reforms that depoliticise energy pricing, such as the introduction of automatic pricing mechanisms."

Furthermore, Roháč (2013e) provides a discussion of prospects of a subsidy reform in Egypt, drawing on the experience of successful energy subsidy reforms in Turkey, Philippines, Brazil, Chile, Kenya and Uganda. These reforms tended to be implemented by governments with strong popular mandates. In all of these examples above, some mitigation or compensation schemes were used to balance the impact of the reforms on the population. Growing fiscal imbalances seemed as a powerful impetus for reform. Finally, in all of the cases, subsidy reforms were a part of a larger reform packages that aimed to improve the functioning of energy markets. In contrast, Nigeria's failed subsidy reform is an extreme example of how such reforms can be derailed if the population has a low level of trust in the government, which it perceives as essentially self-interested, if not predatory (Commander 2012: 25-26).

credibility at the forefront of the discussion leads to a departure from an approach that sees subsidies as a technical problem that can be addressed by political fiat, particularly because our approach stresses the need for a quick and complete reform.

#### **6.1.1 Completeness, speed, and simplicity**

In the absence of credibility, incomplete and gradual reforms are vulnerable.<sup>226</sup> To signal its determination to reform, the government should opt for the costlier route of quick and complete reform, even though it can induce larger dislocations in the economy.

Besides signalling, a complete reform helps the government to tie its own hands. The quicker the reform, the earlier constituencies emerge that will find it in their interest to defend the new status quo. It is true that there are few examples of successful wholesale reforms of subsidies, but gradual reforms, as implemented in the Middle East and North Africa, tend to be reversed later. Although, in theory, a gradual reform may be the correct prescription for governments that can credibly commit to a reform path, over a number of years, it is unlikely to be an advisable path to follow in Egypt, precisely because of the difficulty of making a credible commitment.

Furthermore, a reformer would raise the costs of reversal by limiting the capacity of the Egyptian government to provide commodity subsidies, by closing down of government offices such as the General Authority for the Supply of Commodities or the sections of the Ministry of Petroleum in charge of price regulation of oil products.

#### **6.1.2 Compensation**

A successful subsidy reform will need to command the support of a large part of the population. This is difficult if the reform imposes economic costs on a large part of the

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<sup>226</sup> Rodrik (1988) demonstrates that the speed of reforms – as well as “going overboard” and pursuing more radical reforms than would be normally justified on welfare grounds – can be used as a signal of commitment to the reform process. Boettke (1995) provides a discussion of how a lack of credibility derailed economic reforms in post-communist Russia.

population. One manifestation of those costs is the increase in poverty levels that would follow the elimination of subsidies without any accompanying compensation scheme.<sup>227</sup> However, it would not be only the poor households that would be affected by a removal of subsidies, but rather much broader segments of the population – something that needs to be taken into account in redesigning the existing social safety net<sup>228</sup> and introducing compensatory payments.<sup>229</sup> Besides extending aid to vulnerable groups, policymakers will also need to compensate a large part of the affected individuals in order for the reform to command popular support. The key to solving the subsidy problem in a way that is politically feasible and sustainable is therefore to exploit the savings involved in eliminating the subsidy system.

### **6.1.3 Complementary reforms**

From the perspective of the Egyptian population, the subsidies for food and energy shield ordinary Egyptians from fluctuations in their prices that would otherwise adversely affect their welfare. Provided that spending on food and fuels represents a significant portion of consumer spending in the country, any changes to subsidies will need to be accompanied by credible anti-inflationary measures on the part of the central bank. Post-communist transitions can provide instructive examples, because large price liberalisations there created inflationary pressures, with which some of the countries coped better than others. In the months following the quasi-complete price liberalisation in Czechoslovakia in 1991, the country managed to contain inflationary pressures by restrained monetary and fiscal policies.<sup>230</sup> To the extent to which monetary inflation

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<sup>227</sup> Aboulenein et al. (2009) provide a CGE estimation of the welfare effects of a subsidy reform in Egypt under different compensation schemes. While the richest households would be affected the most by an elimination of energy subsidies, rural households would be affected as well, since they rely on LPG and diesel oil as the main sources of energy. The paper concludes that gradual price increases, accompanied by cash transfers targeted at poorer segments of the population would induce the smallest economic distortions and would be favourable for the income distribution.

<sup>228</sup> Egypt's main vehicle of social assistance is the Social Relief Programme, directed at extremely poor families outside of the labour force.

<sup>229</sup> E.g. Vagliasindi (2012).

<sup>230</sup> See Drábek, Janáček and Tůma (1993).

creates uncertainty about price hikes of food and energy, a successful subsidy reform will likely require that the monetary pressures on prices be contained.

Although food prices in the country are driven by the international prices, substantial downward rigidity exists, which means that falls in the international prices of certain commodities are not translated into decreases in prices for Egyptian consumers.<sup>231</sup> Such downward rigidity reflects a lack of competition on food markets. The policies that accompany the administration of the subsidies, such as licensing laws, damage competition and contribute to food insecurity in the country. Although the country faces severe resource constraints when it comes to land and water, the government is encouraging the production of cereal crops, with per-hectare yields that are a fraction of the developing countries average.<sup>232</sup>

Fully integrated markets in food and energy do not exist in the Middle East and North Africa. The Egyptian government could facilitate trade integration particularly by removing the most egregious barriers. The country ranks very poorly on World Bank's Logistics Performance Index (92<sup>nd</sup> in the world),<sup>233</sup> mainly because of complicated border clearance procedures, poor quality of road freight and railroads, and a lack of ability to reliably trace and track shipments. It remains an open question to what extent the poor state logistics and transport is a result of public underinvestment in infrastructure and to what it simply reflects the vested interests, which may be extracting rents in the form of bribes.

The energy sector too has been marked by heavy-handed government involvement. The combination of subsidised prices and government-controlled refining and distribution of petroleum products deters entry and leads to persistent shortages. The government-operated Egyptian General Petroleum Corporation controls a large part of oil production

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<sup>231</sup> Castel (2012: 7), Albers and Peeters (2013).

<sup>232</sup> Castel (2012: 22).

<sup>233</sup> Arvis et al. (2010).



and upstream activities, including imports of crude oil and refining. Similarly, Egyptian Natural Gas Holding Company, run by the government, manages not only the exploration of natural gas, but also controls other aspects of the natural gas industry, including the use of liquefied natural gas. The government is involved in downstream activities as well. In terms of sales of gasoline, 33.5 percent of the Egyptian market is captured by the government-run Misr Petroleum and another 30 percent is controlled by Petroleum Cooperative Society, Co., an arm of the Egyptian General Petroleum Corporation.<sup>234</sup>

As a result, a subsidy reform in the area of energy ought to be accompanied by a systematic restructuring and privatisation of this sector. Different activities conducted by the Egyptian General Petroleum Corporation and other state-owned companies can be unbundled and privatised, and a liberalisation of prices needs to take place. In this sense, Egyptians can learn from the successful subsidy reforms in countries where the removal of subsidies was accompanied by a thorough restructuring of the sector, improving access, quality and reliability of supply, and bringing in competition.

Furthermore, seemingly unrelated economic reforms could generate further support for the changes, especially among the urban poor. Currently, up to 17 million Egyptian live in informal areas around cities.<sup>235</sup> The informal nature of the dwellings reduces their value relative to situation where there are regularised property titles. So far, the attempts to regularise informal ownership in those areas have been isolated<sup>236</sup> – yet evidence suggests that legalised property titles would empower the poor and enable them to use their dwellings in market exchanges, as collateral and so on.<sup>237</sup> Reformers could therefore accompany the necessarily difficult subsidy reform with a titling reform, which would likely prove popular among poorer segments of the Egyptian society –

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<sup>234</sup> Dutch Ministry of Economic Affairs (2009).

<sup>235</sup> Egypt Human Development Report 2010 (2010).

<sup>236</sup> Soliman (2004).

<sup>237</sup> De Soto (2000).

although arguably this raises the question of whether such a reform could be implemented in a sufficiently short time frame .

## **6.2 Political economy of Islam**

Our second case study, Chapter 4, investigates the surprising effects that credibility problems can engender within the political landscape of transitional countries, with a focus on the new and emerging democracies of the Middle East and North Africa. The chapter outlines a rational choice-based explanation for the rise of political Islam, in which religious political parties are able to address the problem of credible commitment ubiquitous in new democracies. Instead of having to rely on patronage as the only mechanism of making pre-electoral commitments, Islamic parties are able to directly make credible promises about the supply of public goods. This is because they already have a history and a reputation, which serve as mechanisms for making credible pre-electoral commitments. Their reputation relies on a track record of providing social services in environments where governments have failed to do so. Furthermore, we argue that their religious nature makes them well equipped to overcome collective action problems.

While this chapter is not susceptible to yield immediate and detailed practical lessons for policymakers – like the chapter on Egypt’s commodity subsidies does – it can be a source of a important insights that can inform Western foreign policy towards the countries of the Middle East and North Africa. If our account of Islamic politics is correct, then the efforts to eradicate religious political groups from the political landscape may easily backfire. Organisations that possess a distinct advantage at producing club goods and local public goods are also particularly well-positioned to engage in political violence. And, as Krueger (2007) argued, the exclusion of such parties from the democratic political process can be a source of grievances that will serve as an incentive for those organisations to continue the political struggle through

violent means. As a result, the direct implication of this study of political Islam is that competitive political process is essential. Competitive politics and democratic accountability will incentivise other political groups to invest in channels of communication and promise verification that will enable them to make credible pre-electoral commitments, leading to an erosion of the electoral advantage that Islamic parties may enjoy in some transitional countries.

### **6.3 Market-related beliefs and policy preferences in Czechoslovakia**

Our final paper, Chapter 5 in this collection, studies the role of cognitive constraints in shaping the transitional outcomes, with a focus on post-communist Czechoslovakia. It shows that systematic differences in policy preferences existed between Czechs and Slovaks in the early 1990s. In spite of having lived in the same institutional environment for almost 75 years and in spite of being subjected to the same policy shocks in that period, the Czechs displayed significantly stronger pro-market attitudes than the Slovaks. Those differences were not explained by a variation in ‘collective memory’ of the pre-communist era, differences in the levels of economic development before communism, differences in religiosity, legal origins or past institutions. To a limited extent, the differences in policy preferences can be accounted for by the expected costs of transition in different areas of Czechoslovakia, as measured by the unemployment rate in 1994, after the core of the initial economic reforms had been adopted. The paper also provides a historical narrative that explains how the observed differences in market attitudes affected policy outcomes in both countries in the initial phases of the transition.

The conclusions of this chapter are perhaps the most uncertain and tentative. It appears, however, that processes of economic reform and of institutional change cannot be dissociated from the underlying structure of popular beliefs – or *mētis*. Although our work presented in Chapter 5 did not establish that *mētis* exercised a causal effect on the

creation of policies, the existence of such causal link appears to be a tempting possibility, which needs to be verified by future research that can convincingly address the identification problems involved.

Finally, let us recall that the goal of this thesis was not to provide an all-encompassing model of policy change and transitions. It merely purported to show that an approach that takes into consideration the role played by cognitive constraints (*mētis*) and policy in shaping policy making and institutional change can provide a lot of mileage in explaining otherwise perplexing aspects of political economy of reforms. The case studies chosen in this thesis have been chosen to illustrate this claim and hopefully they will encourage other scholars to focus their attention on issues of credible commitment and beliefs – or on *incentive-related* and *cognitive constraints* to policymaking – which we believe still present important and largely unexploited opportunities for future research.

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## Data

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## Appendix to Chapter 4

Table 8 Islamic parties in the Middle East and North Africa

Country	Party	Year Founded
Algeria	Islamic Renaissance Movement (Harakat An-Nahda Al-Islāmiyya)	1992
	Movement of Society for Peace* (Harakat mujtama' as-silm)	1990
	Movement for National Reform (Harakat Al-Islah Al-Wataniy)	1999
Egypt	Freedom and Justice Party* (Hizb Al-Hurriya wa Al-'Adala)	2011
	Al Nour	2011
Jordan	Islamic Action Front* (Jabhat al-'Amal al-Islami)	1992
Tunisia	Ennahda Movement (Harakat an-Nahdah)	1981
Morocco	Justice and Development Party* (Hizb Al-Adālah Wal-Tanmiyah)	1967
Libya	Justice and Construction Party* (Hizb Al-Adala Wal-Bina)	2012
Lebanon	Islamic Group* (El Gama'a El-Islamiyya)	1964
	Party of God (Hezbollah)	1982
Syria	Muslim Brotherhood* (Al-Ikhwan Al-Muslimun fi Suriya)	1935
Palestinian territories	Islamic Resistance Movement* (Harakat al-Muqāwamah al-Islāmiyyah)	1987
Yemen	Yemeni Congregation for Reform* (Al-Tajammu'u Al-Yamani Lil-Islah)	1990

\* Part of the Muslim Brotherhood

Table 9 Arab Barometer - Variable Description (1). Dependent variables

<b>Dependent variables</b>	
People often differ in their views on the characteristics that are essential to democracy. If you have to choose only one thing, what would you choose as the most important characteristic? (231q)	
<i>Elections</i>	Opportunity to change the government through elections
<i>Freedom to criticize</i>	Freedom to criticize the government/those in power
<i>Small income gap</i>	A small income gap between rich and poor
<i>Necessities for everyone</i>	Basic necessities like food, clothing, shelter for everyone
How much do you agree or disagree with the following statements? (232q) (Answers: 1 - Strongly agree, 2 - Agree, 3 - Disagree, 4 - Strongly disagree)	
<i>Bad economy in democracies</i>	In a democracy, the economy runs badly
<i>Democracies indecisive</i>	Democracies are indecisive and too much quibbling
<i>Disorder in democracies</i>	Democracies are not good at maintaining order
<i>Democracies best</i>	Democracy may have its problems but is better than any other form of government
To what degree would you agree that the violation of human rights in [country] is justifiable in the name of promoting security and stability? (234q) (Answers: 1 - Completely justified, 2 - Somewhat justified, 3 - Not very justified, 4 - Not justified at all)	
<i>Human rights violations OK</i>	
In your opinion which of the following is the most important problem facing [respondent's country] today? (without Palestine 248q)	
<i>Economy</i>	<i>Economic situation (poverty, unemployment, inflation)</i>
<i>Corruption</i>	Corruption
<i>Authoritarianism</i>	Authoritarianism
<i>U.S. occupation of Iraq</i>	Ending the US occupation of Iraq
<i>Arab-Israeli conflict</i>	The Arab-Israeli conflict



Table 10 Arab Barometer - Variable Description (2). Explanatory variables

Explanatory variables	
<i>Age</i>	Age, in years (701q)
<i>Age2</i>	Age squared
<i>lnIncome</i>	Log of family monthly Income in 2006 international dollars (716q)
<i>Male</i>	Sex: male (q702)
<i>Uni</i>	Education: college diploma or higher (q703)
<i>Secondary</i>	Education: secondary (q703)
<i>Primary</i>	Education: elementary or primary (q703)
<i>Muslim</i>	Religion: Muslim (q711)
<i>Christian</i>	Religion: Christian (q711)
<i>Druze</i>	Religion: Druze (q711)
<i>Married</i>	Marital status: Married (q709)
<i>Involved Citizen</i>	Are you a member of any organizations or formal groups? (202q)
<i>Political Islam</i>	First principal component of variables q4011, q4012, q4013, q4014 (below)
How much do you agree or disagree with each of the following statements? (1 – Strongly agree, 2 – Agree, 3 – Disagree, 4 – Strongly disagree)	
<i>q4011</i>	Men of religion should not influence how people vote in elections
<i>q4012</i>	It would be better for [respondent's country] if people with strong religious beliefs held public office
<i>q4013</i>	Men of religion should have influence over the decisions of government
<i>q4014</i>	Religious practice is a private matter and should be separated from socio-political life

Table 11 Factor loadings and unique variances

Variable	Factor 1 ( <i>PoliticalIslam</i> )	Uniqueness
q4011	0.4651	0.7837
q4012	-0.8389	0.2963
q4013	-0.8515	0.2749
q4014	0.6173	0.6189

Table 12 Political religiosity and policy preferences. Logit regressions (1-4). Country fixed effects

	What would you choose as the most important characteristic of democracy?			
	(1)	(2)	(3)	(4)
	Elections	Freedom to criticize	Small income gap	Necessities for everyone
Age	-0.010 (0.018)	0.024 (0.021)	-0.023 (0.018)	0.007 (0.018)
Age2	0.000 (0.000)	-0.000 (0.000)	0.000 (0.000)	-0.000 (0.000)
lnIncome	0.061 (0.055)	0.196*** (0.064)	-0.122** (0.058)	-0.151*** (0.056)
Male	0.483*** (0.085)	-0.005 (0.093)	-0.236*** (0.091)	-0.307*** (0.086)
Uni	0.218 (0.214)	0.234 (0.241)	0.115 (0.225)	-0.484** (0.209)
Secondary	0.128 (0.214)	0.070 (0.240)	0.037 (0.228)	-0.059 (0.205)
Primary	-0.182 (0.209)	-0.021 (0.235)	0.129 (0.219)	0.217 (0.197)
Muslim	0.358 (0.221)	-0.848*** (0.258)	-0.404* (0.234)	0.682*** (0.227)
Christian	0.345 (0.229)	-1.066*** (0.265)	-0.119 (0.231)	0.401* (0.233)
Druze	-0.633 (0.410)	-0.202 (0.368)	0.671** (0.329)	-0.037 (0.386)
Married	-0.243** (0.109)	-0.019 (0.116)	0.088 (0.117)	0.178 (0.108)
Involved Citizen	0.220** (0.104)	-0.041 (0.122)	0.115 (0.122)	-0.369*** (0.123)
<b>Political Islam</b>	<b>0.137*** (0.047)</b>	<b>-0.040 (0.051)</b>	<b>-0.040 (0.052)</b>	<b>-0.059 (0.049)</b>
N	3162	3162	3162	3162

Robust standard errors in parentheses, \* p<0.1, \*\* p<0.05, \*\*\* p<0.01. Full description of variables used can be found in Tables 9 and 10 in the appendix.

Table 13 Political religiosity and policy preferences. Ordered logits (5-10). Country fixed effects

	How well or badly is the government managing the following matters? (1- very well, 2-well, 3-badly, 4-very badly)					
	(5)	(6)	(7)	(8)	(9)	(10)
	Managing Economy	Creating Jobs	Narrowing Gap	Improving Health	Improving Education	Improving Morality
Age	0.016 (0.013)	0.001 (0.014)	0.019 (0.014)	0.028** (0.013)	0.036*** (0.013)	0.030** (0.014)
Age2	-0.000 (0.000)	0.000 (0.000)	-0.000 (0.000)	-0.000** (0.000)	-0.000** (0.000)	-0.000* (0.000)
lnIncome	-0.181*** (0.041)	-0.147*** (0.042)	-0.120*** (0.043)	-0.109** (0.042)	-0.177*** (0.042)	-0.042 (0.045)
Male	0.070 (0.058)	0.111* (0.058)	0.224*** (0.060)	0.224*** (0.057)	0.203*** (0.059)	0.360*** (0.060)
Uni	0.157 (0.117)	0.219* (0.118)	0.210* (0.119)	0.152 (0.116)	0.282** (0.122)	0.250** (0.123)
Secondary	0.022 (0.118)	0.153 (0.118)	0.125 (0.118)	-0.002 (0.119)	0.128 (0.126)	0.217* (0.122)
Primary	0.059 (0.106)	0.169 (0.105)	0.138 (0.106)	0.016 (0.104)	0.166 (0.113)	0.185* (0.108)
Muslim	1.306*** (0.297)	0.628** (0.317)	-0.350 (0.313)	-0.608* (0.316)	0.326 (0.314)	-0.917*** (0.330)
Christian	1.580*** (0.338)	0.858** (0.353)	0.007 (0.352)	-0.310 (0.351)	0.474 (0.347)	-0.551 (0.370)
Druze	0.117 (0.361)	1.265*** (0.419)	0.549 (0.424)	-1.801*** (0.375)	-0.828** (0.364)	-0.210 (0.434)
Married	0.069 (0.071)	-0.061 (0.073)	-0.035 (0.072)	-0.080 (0.070)	0.019 (0.071)	-0.009 (0.074)
Involved Citizen	-0.127* (0.077)	-0.199*** (0.076)	-0.155* (0.079)	-0.135* (0.075)	-0.102 (0.078)	-0.341*** (0.081)
<b>Political Islam</b>	<b>0.006</b> <b>(0.036)</b>	<b>-0.030</b> <b>(0.036)</b>	<b>-0.009</b> <b>(0.036)</b>	<b>-0.055</b> <b>(0.035)</b>	<b>-0.008</b> <b>(0.036)</b>	<b>-0.003</b> <b>(0.037)</b>
N	4372	4427	4317	4463	4469	4080

Robust standard errors in parentheses, \* p<0.1, \*\* p<0.05, \*\*\* p<0.01. Full description of variables used can be found in Tables 9 and 10 in the appendix.

Table 14 Political religiosity and policy preferences. Ordered logits with country fixed effects

	Violation of human rights justifiable?	What is the most important problem facing your country today?				
	(9) Human rights violations OK	(10) Economy	(11) Corruption	(12) Authoritarianism	(13) U.S. occupation of Iraq	(14) Arab-Israeli conflict
Age	0.009 (0.014)	-0.014 (0.018)	0.040** (0.020)	-0.029 (0.035)	0.037 (0.080)	-0.042 (0.040)
Age2	-0.000 (0.000)	0.000 (0.000)	-0.000** (0.000)	0.000 (0.000)	-0.000 (0.001)	0.000 (0.000)
lnIncome	-0.055 (0.044)	-0.084 (0.059)	0.089 (0.063)	0.096 (0.132)	0.416* (0.231)	-0.108 (0.163)
Male	0.042 (0.060)	-0.304*** (0.071)	0.346*** (0.080)	-0.024 (0.164)	-0.361 (0.314)	0.224 (0.179)
Uni	0.248** (0.112)	-0.070 (0.133)	0.142 (0.146)	0.548 (0.343)	-1.087* (0.613)	-0.407 (0.337)
Secondary	0.066 (0.114)	-0.136 (0.139)	0.090 (0.154)	0.844** (0.344)	-0.938 (0.604)	-0.504 (0.340)
Primary	-0.005 (0.099)	0.015 (0.117)	-0.071 (0.131)	0.451 (0.321)	-1.199** (0.469)	-0.170 (0.292)
Muslim	1.344*** (0.320)	0.826** (0.410)	-0.870* (0.444)	-2.099* (1.107)	-3.105* (1.884)	1.155 (1.065)
Christian	1.885*** (0.362)	0.243 (0.447)	-0.556 (0.486)	-1.683 (1.139)	dropped	2.043* (1.154)
Druze	2.214*** (0.461)	0.696 (0.487)	-0.484 (0.527)	-2.397** (1.196)	dropped	1.079 (1.245)
Married	0.074 (0.070)	-0.050 (0.085)	-0.067 (0.095)	0.216 (0.189)	-0.075 (0.356)	0.411* (0.215)
Involved Citizen	-0.146* (0.078)	-0.099 (0.095)	0.134 (0.103)	0.200 (0.192)	-0.519 (0.538)	-0.260 (0.276)
<b>Political Islam</b>	<b>0.073** (0.035)</b>	<b>-0.039 (0.041)</b>	<b>0.143*** (0.045)</b>	<b>-0.107 (0.097)</b>	<b>-0.233 (0.162)</b>	<b>-0.152 (0.109)</b>
N	4414	3561	3561	3561	3126	3561

Robust standard errors in parentheses, \* p<0.1, \*\* p<0.05, \*\*\* p<0.01. Full description of variables used can be found in Tables 9 and 10 in the appendix.

## Appendix to Chapter 5

Table 15 Policy preferences of Czechs and Slovaks, 2009

<i>(To what extent do you agree or disagree with each of the following statements? 1 Totally agree 2 Tend to agree, 3 Tend to disagree, 4 Totally disagree)</i>		
	<i>Mean</i>	
	<i>Czech</i>	<i>Slovak</i>
The State intervenes too much in our lives	2.30	2.25
Economic growth must be a priority for (OUR COUNTRY), even if it affects the environment	2.59	2.29
Free competition is the best guarantee for economic prosperity	2.17	2.02
<i>From the following items, which two should our society emphasise in order to face major global challenges? (1 if mentioned, 0 otherwise)</i>		
	<i>Mean</i>	
	<i>Czech</i>	<i>Slovak</i>
Social equality and solidarity	.44	.51
Free trade /market economy	.36	.34
And in 2030, in the European Union, would you prefer a society where more importance is given to solidarity, or to individualism? (1 Solidarity, 2 Equal importance, 3 Individualism)	1.43	1.43
<i>Could you please tell me for each of the following, whether the term brings to mind something very positive, fairly positive, fairly negative or very negative. (1 Very positive, 2 Fairly positive, 3 Fairly negative, 4 Very negative)</i>		
	<i>Mean</i>	
	<i>Czech</i>	<i>Slovak</i>
Solidarity	1.89	1.80
Competition	2.07	2.11
Welfare State	2.22	2.13

Source: Eurobarometer surveys ZA4973 and ZA4994, 2009

Table 16 Variable definition and description

<b>Data for 1990-1993 ( Economic Expectations and attitudes, Czechoslovak Academy of Sciences)</b>	
<i>(For the questions below, answers are coded as follows: 1 certainly no, 2 no, 3 yes, 4 certainly yes)</i>	
<i>Money For Competent</i>	It is right that capable and competent people have a lot of money, even millions.
<i>Transform SOEs</i>	All big state enterprises should be transformed into shareholders' companies or private firms.
<i>Only Capitalism</i>	Capitalism represents the only possible course of our future development.
<i>Private Social Care</i>	Would it be right, according to your opinion, that a part of social care, e.g. care for the elderly, would be performed by private institutions?
<i>Private Healthcare</i>	Would you agree with the introduction of private medical care?
<i>(For the question below, answers are coded as follows: 1 certainly yes, 2 yes, 3 no, 4 certainly no)</i>	
<i>Unnecessary Job Positions</i>	Unemployment should be prevented even at the cost of preserving many unnecessary jobs.
<b>Controls</b>	
<i>Age</i>	Age in years
<i>Slovak</i>	1 if Slovak, 0 otherwise
<i>Ln Income</i>	Ln of net personal or household income. (The wording was slightly different in different waves of the survey.)
<i>Married</i>	1 if married, 0 otherwise
<i>Divorced/Widow</i>	1 if divorced or widowed, 0 otherwise
<i>Financially Secure</i>	Reports that getting along with one's income is very easy, easy or rather easy.
<i>Left</i>	Identifies as being 'clearly on the left' or 'on the left' in a self-reported ideology question.
<i>Right</i>	Identifies as being 'clearly on the right' or 'on the right' in a self-reported ideology question.
<i>Above 100</i>	Lives in a city of more than 100 thousand people.
<i>Above 20</i>	Lives in a town of more than 20 thousand people but less than 100 thousand.
<i>University</i>	Highest educational attainment: university education
<i>High School</i>	Highest educational attainment: high school
<i>Vocational</i>	Highest educational attainment: vocational training
<i>Male</i>	1 if male, 0 otherwise
<i>Prague</i>	1 if from Prague, 0 otherwise
<i>Distance from capital</i>	Distance from former royal capital (Prague or Budapest)

<i>Population1880</i>	Population of the capital city of the district in 1880
<i>Unemployment 1994</i>	Unemployment rate in the district in 1994
<i>Industry</i>	District-level share of employment in the industry
<i>Religiosity</i>	District-level share of religious population
<i>Protestants</i>	District-level share of self-reported protestants
<b>Data for 1990-1993 ( Economic Expectations and attitudes, Czechoslovak Academy of Sciences)</b>	
<i>(For the questions below, answers are coded as follows: 1 certainly no, 2 no, 3 yes, 4 certainly yes)</i>	
<i>Money For Competent</i>	It is right that capable and competent people have a lot of money, even millions.
<i>Transform SOEs</i>	All big state enterprises should be transformed into shareholders' companies or private firms.
<i>Only Capitalism</i>	Capitalism represents the only possible course of our future development.
<i>Private Social Care</i>	Would it be right, according to your opinion, that a part of social care, e.g. care for the elderly, would be performed by private institutions?
<i>Private Healthcare</i>	Would you agree with the introduction of private medical care?
<i>(For the question below, answers are coded as follows: 1 certainly yes, 2 yes, 3 no, 4 certainly no)</i>	
<i>Unnecessary Job Positions</i>	Unemployment should be prevented even at the cost of preserving many unnecessary jobs.
<b>Controls</b>	
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